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FEDERAL TAX REFORM

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FEDERAL TAX REFORM

MONDAY, JULY 9, 1984

U.S. SENATE,
COMMITTEE ON THE BUDGET,
Seattle, WA.

The committee met, pursuant to notice, at 2 p.m., in the south auditorium, Federal Office Building, 915 Second Avenue, Seattle, WA, Hon. Slade Gorton, presiding.

Present: Senators Gorton, Durenberger, and Evans.

Staff present: John Wills, legislative assistant.

OPENING STATEMENT OF SENATOR GORTON

Senator GORTON. This hearing of the Senate Budget Committee will come to order.

The subject of the hearing today is Federal tax reform. I am delighted to welcome to Seattle Senator David Durenberger who has come from Minnesota to join with us today. Senator Durenberger is a member of the Finance Committee, which is the Senate's tax-writing committee. So, this hearing today is particularly relevant to him and he to all of you here who are concerned with the Federal tax system. Senator Evans hopes to join us at least briefly later in the day. I want also to thank the witnesses who will appear here this afternoon.

The power to tax is perhaps the Federal Government's single most far-reaching and influential prerogative, touching each of our lives in many ways. For some time there has been a growing consensus that the Federal tax system is in need of fundamental and major reform, and I look forward to hearing a variety of views on this subject in Seattle.

There are a number of reasons why Federal tax reform has increasingly become a subject of general debate. In the most immediate sense it is clear that the Federal Government will need to raise more tax revenue to reduce budget deficits which confront us, and it is important that we do this in the most efficient and fair manner.

Beyond this immediate need, however, we have found ourselves in recent years in a situation in which our Federal tax base has been eroded by numerous special exemptions, deductions, and other tax preferences. Though each was enacted with an apparently worthy goal in mind, in the aggregate they have resulted in a need for higher tax rates for others which increase the incentives to evade and to avoid taxes. They have also raised questions about the degree to which the Federal Government is unintentionally promoting uneconomic and inefficient economic behavior aimed not at reaching worthy social goals, but only at reducing tax liabilities.

COMPLEXITY OF TAX CODE IS SERIOUS PROBLEM

Perhaps the most serious problem, however, is the resulting sheer complexity of the Tax Code and the perception of unfairness which that fosters, a perception which has considerable validity.

Congress has just passed an extraordinarily lengthy and complicated tax bill, approximately 1,000 pages in length. The average taxpayer reads of this or takes a look at the 1040 and related forms and sees a host of credits, exemptions, and deductions for most of which he or she is not eligible. This cannot help but create in his or her mind the impression that someone else is benefiting unfairly, resulting in a larger tax bill for the unlucky ones who have no special privileges to claim. The basic acknowledgment of the citizens that their taxes are being levied fairly is absolutely essential to a free democracy. If necessary, other worthy goals may have to be sacrified to ensure that that perception of fairness is retained.

It is important that we keep a sense of perspective with respect to this problem. Taxation is never going to be popular. And in comparison to the tax regimes of many, indeed most other countries, the U.S. system is a model of justice.

Furthermore, criticisms of the tax code are not criticisms of the men and women of the Internal Revenue Service who have given that institution a well-deserved reputation for integrity and professionalism. Throughout our history there has been a strong tradition of voluntary compliance with Federal tax laws. It is almost impossible to overstate the value of that tradition. It is envied around the world, including other Western industrial nations in which there is no corresponding effort. Maintaining that tradition rests on our ability to reassure the taxpayer that the tax burden is fairly apportioned, the tax laws are open and understandable to all, and that the collection of taxes and the enforcement of tax laws will be evenhanded and without exception.

GOALS COULD BE MET WITH REFORM OF TAX CODE

I believe that all of these goals could be more readily met through a significant simplification and reform of the tax code. I believe that there is a significant possibility that Congress will deal with this subject in 1985. The Treasury Department has been instructed to provide proposals to the President by December of this year. And I am holding this hearing both to inform myself and to encourage public debate on that topic throughout the State of Washington.

And with that I will introduce now my friend and colleague, Senator David Durenberger from Minnesota.

OPENING STATEMENT OF SENATOR DURENBERGER

Senator **Durenberger**. Thank you very much, Slade. As you indicated, I am now in my sixth year in writing tax legislation, and I would like to take responsibility for little or none of it. I can do that as long as I am in the State of Washington. Let me make one observation and start with just a very brief story about one of the last trips from Washington to Minnesota. In an airplane I sat next to an elderly gentleman who turned out to be a tax lawyer. And he said: "Senator, you might appreciate this little story. I put my law firm together and decided to go into tax law in 1954." And he said: "I thought it would be a good idea if every morning when we came to work at 9 o'clock, for 1 hour we read from the Internal Revenue Code.

"So," he said, "every morning, 5 days a week, we all came in at 9 o'clock and we sat there and took turns reading from the Internal Revenue Code for 1 hour."

I said: "Well, how long did it take to read the whole code?"

And he said, "We did it in exactly 3½ months."

Slade knows just this year's modification of the Internal Revenue Code took at least—I think it was 400 pages in the Congressional Record. Those of you who like to bore yourself to sleep at night ought to read the Congressional Record, the fine print in the Congressional Record—400 pages just for this year's modification of the Code.

NOW IS TIME FOR TAX REFORM

So, whether you sit on the tax-writing committee as I have for 6 years or you perceive it from the end of the taxpayer, I think you would agree with what the Senator said in his opening comments about the need for building confidence in not only the fairness, but the goals and objectives of the national portion of a multilevel tax system that we have in this country. We sometimes tend to deal with it when we are in the Senate as though our whole responsibility is the Federal Tax Code. But in this country, from the perception of a Tax Code, you are paying out of the same pocket or the same earnings, whether you are making a contribution to government at the National level or the State level or the local level. And from time to time the pain of a property tax or a sales tax or a State income tax or a Federal income tax will cause you to take a variety of actions such as we have seen in proposition 13 in California, 2½ in Massachusetts, and so forth.

So, as Slade points out, the time is now for reform of the tax system. And I would just add to everyone's dimension of thinking about taxes in America that we try to keep it in an intergovernmental context, that we are taxing at a variety of levels, and that what we do at a national level with regard to a national tax system—whether it is based on income like the current tax or it is based on some other factor such as these consumption tax proposals—that anything we do has a major impact on the tax systems of the State of Washington, of counties, of cities, and so forth. And we ought to take that into consideration when we do it as well.

I welcome the opportunity to get input from a variety of people into this process and the opportunity to be here to respond to the witnesses that you have brought together for this hearing. And I congratulate you on this endeavor.

Senator GORTON. Thank you. In 1974, when Congress reformed the Federal budget process and created, among other things, the House and Senate Budget Committees to oversee the broad pattern—although not the detail—of spending and taxing in the

United States, perhaps its most important creation was the Congressional Budget Office. By its title, it is an agency of the Congress of the United States, and it provides Members of Congress and particularly the Budget Committees with objective advice about the course and impact of both spending and taxing programs. It is valued for that objective advice, frequently at least more neutral in nature than what any national administration is willing to provide.

It has had a distinguished first decade. Our first witness, Rudolph Penner, is the newly appointed Director of the Congressional Budget Office [CBO] and is managing it with the same distinguished regard for the truth and for stating the very real difficulties with which the country and the fiscal system is faced that has graced that Office since its inception. And I am particularly pleased to welcome to Seattle and to this hearing the Director of the Congressional Budget Office, Rudolph Penner. And we are now delighted to hear from you, Rudy.

STATEMENT OF DR. RUDOLPH PENNER, DIRECTOR, CONGRESSIONAL BUDGET OFFICE

Dr. **Penner**. Thank you very much for those remarks, Mr. Chairman, and thank you for inviting me to Seattle to speak today about the importance of tax reform. With your permission, I will summarize my statement, submitting the entire text for the record.

Senator **Gorton**. The entire statement will be included in the record.[1]

Dr. **Penner**. The Federal income tax, which accounts for almost half of the Federal Government's annual revenues, has come under sharp criticism. Public opinion surveys reveal that the personal income tax has now surpassed the homeowners' property tax as the levy taxpayers regard as most unfair. Conspicuous flaws in the system include: The narrowness of the income tax base, the high marginal tax rates most taxpayers face, the complexity of the income tax code and its resulting obscurity, inequities that cause taxpayers in similar economic circumstances to face different tax burdens, and the income tax's bias against saving.

THE SCOPE OF THE INCOME TAX BASE

A major problem over time has involved the erosion of the income tax base. Although the gross national product [GNP] differs somewhat from the concept of economic income—notably, in its exclusion of capital gains and its inclusion of depreciation—this measure can be used as a convenient starting point to illustrate the erosion of the tax base.

The CBO's forecast of the Nation's GNP for 1984 is nearly $3.7 trillion. Of this total, roughly 45 percent is not subject to tax. Much of this amount is untaxed because it represents costs of doing business or is never received by individuals—for example, depreciation and employers' social insurance contribution. However, among the kinds of income that escape taxation are fringe benefits, such as health insurance, that firms provide to their employees and unreported income. These two categories account for roughly one-quarter of the untaxed total.

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[1] See p. 9.

The 55 percent of the GNP remaining after these exclusions and some adjustments—for example, inclusion of a portion of capital gains—is referred to as "adjusted gross income" [AGI]. AGI, in turn, is subject to further exclusions, deductions, and exemptions that erode the tax base by another 10 percent to 15 percent. In sum, the taxable base is about 45 percent of GNP and, after taking account of the standard deduction and personal exemptions, this figure drops below 40 percent.

If one were to compute total income taxes as a share of AGI from the data most recently published, this figure would be 15 percent in 1982. A similar measure, based on GNP, would be 9 percent. These figures compare with 19 percent, the actual average tax rate on taxable income in 1982. The difference between either of the first two rates and the actual average suggests the extent to which, in theory, tax rates could be cut if the tax base were further expanded.

HIGH MARGINAL TAX RATES

Because so much income is currently excluded from the tax base, very high rates must be applied to what remains in order to produce the revenues needed to finance Federal activities. A result is undue influence on economic activity, with some individuals and firms pushed out of ordinary economic activities and toward those favored by the tax law. Indeed, most special tax provisions explicitly aim to encourage specific activities. But many of those provisions were designed in the distant past, and whether they still serve their original social or economic purposes is now unclear. Moreover, special provisions often interact in a way that induce unintended results. Some of the more exotic tax shelters are clear examples of this phenomenon.

More generally, the high tax rates on ordinary activities very probably discourage work effort and saving compared to what would occur in a more broad-based system that raised similar amounts of Federal revenue. Though the magnitude of such effects is much disputed, it is generally agreed that the greatest work disincentives affect a family's so-called secondary workers—particularly, employed wives and teenagers.

Perhaps the greatest inefficiencies our tax system produces result from aberrations in the taxation of capital income. Though these distortions apply mainly to corporate activities, they lead to often compounding distortions of the personal income tax. The effective tax rate on the return to a particular investment can vary greatly, depending on whether the investment is corporate or noncorporate, financed by debt or equity, in inventory, equipment, structures, or research and development, domestic or foreign, or encouraged by special tax provisions.

PROBLEMS ARISE FROM EFFECTS OF INFLATION

Further problems arise from the effects of inflation on the measurement of the return to capital. Inflation erodes the real value of depreciation deductions allowed by the tax law. It creates illusory but taxable capital gains on inventory and other investment, and it erodes the real values of the debts owed by firms and individuals. It can therefore significantly raise or lower a firm's effective tax rate on the real return to capital, depending on the characteristics of the firm's balance sheet. In theory, this problem can be solved by indexing the tax base, but this would be so extraordinarily complex as to be impractical.

As a result of the many anomalies in the tax law, effective rates on particular investments can vary from strongly positive to strongly negative. Consequently, the allocation of the Nation's scarce capital resources among various economic activities may be determined more by the incidental effects of tax law than by judgments about where the investment can be most productive for the Nation as a whole.

In fact, the foregoing discussion only scratches the surface. The law has become so complex that most large firms have at least one IRS agent assigned to them full time, and the tax consequences of many transactions have to be negotiated in advance. Indeed, if historical trends continue, there is a danger that the corporate tax in particular could evolve into the worst possible tax, one that greatly distorts investment choices while raising precious little revenue.

INCOME-BASED VERSUS CONSUMPTION-BASED TAXES

For several decades the appropriate basis of taxation has been a subject of fundamental dispute. Most other nations' tax systems have incorporated the notion that tax burdens should in some way be based on a household's yearly ability to pay. For this reason, taxes are paid on a wide range of incomes, and tax structures are generally progressive.

An alternative view of the tax system is that it should be directed less toward the amount of income or output an individual generates and more toward the amount he or she consumes or takes away from the economy. According to this view, savers should be rewarded by being permitted to exempt from taxation however much income they save.

In recognition of this view, some proposals would institute progressive expenditure taxation and eliminate the corporate income tax as now constituted.

I should add here, though my text does not say so, that many proponents of expenditure taxation do propose some sort of cash-flow tax on corporations for technical reasons and also some sort of tax on corporations owned abroad. But we could discuss that in more detail later, if you like.

Expenditure taxation could take several forms: A national sales tax, a value-added tax, or a progressive expenditure tax. Under all such plans, income saved would be tax-exempt. Some observers worry that this approach could result in concentrated accumulations of wealth, and it has been suggested that consumption taxes be complemented by taxes on gifts and bequests. This could, however, somewhat discourage saving, though probably less than the current income tax does.

EXPENDITURE TAX APPEALING BECAUSE OF SIMPLICITY

In addition, an expenditure tax approach has some appeal because of its simplicity. It would do away with the complications created by the corporate tax and more generally would do away with the many layers of the tax code devoted to defining capital income. For example, concern about the effects of inflation on the tax base would vanish, as would the need to determine depreciation and the need to differentiate capital gains from regular income.

I do not mean to imply that an expenditure tax would be simple. No tax ever is. Because consumer expenditures for durable goods can be lumpy—for example, in the case of buying automobiles or houses—averaging becomes much more important in such a system. Particularly difficult problems would attend the transition to an expenditure tax. It would probably be deemed unfair to tax consumption financed with savings accumulated from after-tax income during the superseded income tax regime. Dealing with this problem can quickly become extremely complicated.

THE TAX CODE'S COMPLEXITY

Taxpayers' complaints about the complexity of the current income tax, as I think your opening statement suggested, may derive less from their own experiences than from impressions about their neighbors' use of the Tax Code. Roughly two-thirds of all tax filers did not claim itemized deductions in 1982, and almost 40 percent used a short form. At the same time, the number of taxpayers who turned to professional tax preparers increased to 40 percent.

Taxpayers' concern about complexity may be motivated by the wish to discover what loopholes may have been overlooked. This concern is reinforced by the numerous special-purpose provisions in the tax code for which most tax filers are ineligible. But even with the IRS's ingenuity—and I think they are brilliant in this regard—in designing fairly simple tax forms, given the complexity of the law, that complexity makes it almost impossible for filers to define from the forms what the underlying tax law really is. For example, filers using tax tables to determine their liabilities cannot easily tell what tax rate brackets they are in. Not knowing why one has a certain tax liability has to be frustrating.

SIMPLIFICATION COULD DIMINISH TAX EVASION

Diminished tax evasion is another argument made for simplification. The multitude of tax preferences available today may encourage ineligible persons to seek tax avoidance in other ways. Elimination of special provisions might give the impression of a more equitable system, making lower tax rates possible and compliance more attractive. The result could draw income from the underground economy to the tax mainstream. But because so little is known about the underground economy—we do not know how much income currently goes reported—how much could be claimed is really unclear. For policymakers to rely on this phenomenon as a major source of additional source of Federal tax revenue would therefore seem imprudent.

FAIRNESS

The ever-changing notion of how progressive the current tax code should be is evidence enough of the fact that equity is an elusive and contentious concept. Over the years, the combination of legislative changes and inflation-induced bracket creep have made the tax system more progressive during some periods and have moved it in the opposite direction during others.

Motivated by efforts to accommodate concerns about distributional effects, many of the tax reform plans circulating through the Congress highlight the fact that their effects on the distribution of tax burdens by major income groups change only slightly from current law. Any significant reform, however, will radically influence the distribution of tax burdens within income groups. Reform could also result in capital losses on assets, losing special tax privileges, and attendant gains on other capital assets. The prospect of such adjustment problems has been a major factor impeding reform in the past. But I should note that, if we can enact a system that is truly efficient, a net gain in the value of all assets that grows over time should follow.

SOCIETY COULD BE A WINNER

As the income tax laws grow more complex, the case for tax reform gains strength. That the current level of Federal revenues could be achieved with greater efficiency, simplicity, and fairness seems clear.

But reform in itself can cause problems, with some big winners and big losers both from changes in the taxation of income flows and from the capital gains and losses that those changes induce. The current system is so complex that predictions of who those winners and losers stand to be in the short and long run is virtually impossible. To the extent that a more efficient and equitable system can be designed, the pains of the transition period can be eased by the fact that society as a whole will be a net winner.

Thank you very much, Mr. Chairman.

Senator GORTON. Thank you, Mr. Penner.

[The prepared statement of Dr. Penner follows:]

STATEMENT OF RUDOLPH G. PENNER, DIRECTOR, CONGRESSIONAL BUDGET OFFICE

Mr. Chairman, thank you for inviting me to speak today about the importance of tax reform.

PROBLEMS WITH THE CURRENT SYSTEM

The federal income tax, which accounts for almost half (48 percent in 1983) of the federal government's annual revenues, has come under sharp criticism. Public opinion surveys reveal that the personal income tax has now surpassed the homeowners' property tax as the levy taxpayers regard as most unfair. Conspicuous flaws in the system--noted both by taxpayers in general and by policymakers in particular--include:

- The narrowness of the income tax base,
- The high marginal tax rates most taxpayers face,
- The complexity of the income tax code and its obscurity for most filers,
- Inequities that cause taxpayers in similar economic circumstances to face different tax burdens, and
- The income tax's bias against saving.

PROPOSED REFORMS

Such criticisms have led to reviews of current policy and proposals for reform in both the Congress and the Administration. Several Members of Congress have introduced schemes, though these vary widely from plan to plan. Some would continue a trend that emerged in 1982, when the Congress passed the Tax Equity and Fiscal Responsibility Act (TEFRA). That law broadened the existing income tax base by restricting certain deductions and exclusions then in the tax code. The tax bill just passed by the 98th Congress--the Tax Reform Act of 1984--continues this strategy.

Other, more sweeping plans combine base broadening with reductions in tax rates. While some plans would retain a structure of graduated tax rates, others would have only one uniform, or "flat," tax rate. Even more radical approaches would shift the burden of tax from income to consumption. For example, they would exempt all forms of saving from tax, or eliminate the corporate income tax and replace it and the individual income tax with some form of national sales tax. The theory behind all such proposals is that the current tax system penalizes savers and investors, and because savings are essential to the nation's economic growth, the system must be changed.

Together, the array of reform measures now under review responds to many of the income tax's perceived shortcomings. In my remaining time, I would like to examine the sources of these perceptions and discuss possible remedies for these problems, in light of the tax code as it now stands and what is known about economic behavior.

The Scope of the Income Tax Base

"Economic income" as used in the discussion of tax issues has been defined either as the sum of income from various sources--wages and salaries, capital gains, interest on savings, rents, dividends--or alternatively, as a household's consumption plus the change in its net worth. This definition is somewhat different from the way incomes are reported to the Internal Revenue Service (IRS) and tracked by the Department of Commerce. Although the gross national product (GNP--that is, the total value of U.S. goods and services produced) differs somewhat from the concept of economic income--notably in its exclusion of capital gains and its inclusion of depreciation--this measure can be used as a convenient starting point to illustrate the erosion of the tax base.

The Congressional Budget Office's forecast of the nation's GNP for 1984 is nearly $3.7 trillion. Of this total, roughly 45 percent is not subject to tax. Much of this amount is untaxed because it represents costs of doing business or is never received by individuals, for example, depreciation and employer's social insurance contributions. However, among the kinds of income that escape taxation are fringe benefits (such as health insurance) that firms provide to their employees and unreported income. These two categories account for roughly one-quarter of the untaxed total.

The 55 percent of GNP remaining after these exclusions and some adjustments--for example, to include capital gains--is referred to as "adjusted gross income" (AGI). AGI, in turn, is subject to further exclusions, deductions, and exemptions that erode the tax base by another 10 percent to 15 percent. In sum, the taxable base is about 45 percent of GNP, and after taking account of the standard deduction and personal exemptions available to all taxpayers, this figure drops below 40 percent.

If one were to compute total income taxes as a share of AGI from the data most recently published, this figure, which represents the average tax rate on AGI, would be 15 percent for 1982. A similar measure based on GNP would be 9 percent. These figures compare with 19 percent, the actual average tax rate on taxable income in 1982. The difference between either of the first two rates and the actual average rate suggests the extent to which, in theory, tax rates could be cut if the tax base were further expanded.

Inclusion of additional income items in the tax base, as proposed under several tax reform proposals, would reduce the disparities in the tax treatment of taxpayers with similar economic incomes. Fringe benefits, for example, being tax free, permit workers who receive a larger portion of their compensation in this form to pay taxes at lower rates than do other employees. This provision also encourages workers to request compensation in this untaxed form, regardless of whether they would prefer such non-monetary benefits to cash payments, were there not tax considerations.

As evidenced by recent data on 1981 tax returns, current tax provisions result in a wide disparity of tax rates for individuals with similar incomes, without regard to the level of their incomes. For example, taxpayers with 1981 AGIs between $4,000 and $6,000 faced tax rates on their last dollar of income earned between zero and 19 percent; those with incomes between $200,000 and $500,000 faced rates between 24 percent and 70 percent.

Even with changes that brought about further base broadening, certain deductions and exclusions in the present tax code—such as personal exemptions or deductions for charitable contributions--would still be regarded as appropriate and would probably not be eliminated. If one preserved these and similar provisions, but included all other non-taxed forms of income, the tax base could potentially be increased by 50 percent.

High Marginal Tax Rates

Because so much income is currently excluded from the tax base, very high rates must be applied to what remains in order to produce the revenues needed to finance federal activities. A result is undue influence on economic activity, with some individuals and firms pushed out of ordinary economic activities and toward those favored by the tax law. Indeed, most special tax provisions explicitly aim to encourage specific activities. But many of those provisions were designed in the distant past, and whether they still serve their original social or economic purposes is now unclear. Moreover, special provisions often interact in ways that induce unintended results. Some of the more exotic tax shelters are clear examples of this phenomenon.

More generally, the high tax rates on ordinary activities very probably discourage work effort and saving compared to what would occur in a more broad-based system that raised similar amounts of federal revenue. Though the magnitude of such effects is much disputed, it is generally agreed that the greatest work disincentives affect a family's so-called "secondary workers"--primarily, employed wives and teenagers.

Perhaps the greatest inefficiencies our tax system produces result from aberrations in the taxation of capital income. Though these distortions apply mainly to corporate activities, they lead to often-compounding distortions of the personal income tax. The effective tax rate on the return to a particular investment can vary greatly, depending on whether the investment is:

- Corporate or noncorporate,
- Financed by debt or equity,
- In inventory, equipment, structures, or research and development,
- Domestic or foreign, or
- Motivated by special tax inducements.

Further problems arise from the effects of inflation on the measurement of the return on capital. Inflation erodes the real value of the depreciation deductions allowed by the tax law. It creates illusory--but taxable--capital gains on inventory and other investments, and it erodes the real value of the debts owed by firms and individuals. It can therefore significantly raise or lower a firm's effective tax rate on the real return to capital, depending on the characteristics of the firm's balance sheet. In theory, this problem can be solved by indexing the tax base, but this would be so extraordinarily complex as to be impractical. (Note that the problem of indexing the tax base is very different from indexing the tax rate structure to prevent "bracket creep." The latter is relatively simple and is to be done for the individual income tax starting in 1985.)

As a result of the many anomalies in the tax law, effective tax rates on particular investments can vary from strongly positive to strongly negative. Consequently, the allocation of the nation's scarce capital resources among various economic activities may be determined more by the incidental effects of tax law than by judgments about where investment can be most productive for the nation as a whole.

In fact, the foregoing discussion only scratches the surface. The law has become so complex that most large firms have at least one IRS agent assigned to them full time, and the tax consequences of many transactions have to be negotiated in advance. Indeed, if historical trends continue, there is a danger that the corporate tax in particular could evolve into the worst possible tax--one that greatly distorts investment choices while raising precious little revenue.

Income-Based Versus Consumption-Based Taxes

Our society seems always to have been a bit ambivalent about whether income or consumption should be the basis for the tax system. No absolute answers are available to guide policymakers about which constitutes the most appropriate tax base. The present code contains tax-base features designed to accommodate both schools of thought. Thus, most sources of income are taxed, but many special provisions favor saving and investment.

For several decades, the appropriate basis for taxation has been a subject of fundamental dispute. Most other nations' tax systems have incorporated into their tax structures the notion that tax burdens should in some way be based on a household's yearly ability to pay. For this reason, taxes are paid on a wide range of incomes, and tax structures are generally progressive--that is, the more income a taxpayer has, the greater a portion of it he or she pays in tax.

An alternative view of the income tax is that it should be directed less toward the amount of income or output an individual generates and more toward the amount he or she consumes or takes away from the economy. According to this view, savers should be rewarded by being permitted to exempt from taxation however much income they save. To put it another way, taxpayers' consumption can be taken as their own assessment of their ability to pay. Consumption depends on considerably more than one year's income; income earned in prior years--a critical determinant of taxpayers' overall wealth—is also important to one's ability to pay taxes.

In recognition of this view, some proposals would institute progressive "expenditure" taxation and eliminate the corporate income tax altogether. Expenditure taxation could take several forms: a national sales tax, a value-added tax, or a progressive expenditure tax.

Under all such plans, income saved would be tax-exempt. Some observers worry that this approach could result in concentrated accumulations of wealth, and it has been suggested that consumption taxes be complemented by taxes on gifts and bequests. This could, however, somewhat discourage saving, though probably less than the current income tax does.

In addition, an expenditure tax approach has some appeal because of its simplicity. It would do away with the complications created by the corporate tax, and more generally, would do away with the many layers of the tax code devoted to defining capital income. For example, concern about the effects of inflation on the tax base would vanish, as would the need to determine depreciation, and the need to differentiate capital gains from regular income.

I do not mean to imply that an expenditure tax would be simple. No tax ever is. Because consumers' expenditures for durable goods can be lumpy--for example, house or car purchases can occur at odd or long intervals--averaging would become more important. Particularly difficult problems would attend the transition to an expenditure tax. It would probably be deemed unfair to tax consumption financed with savings accumulated from after-tax income during the superseded income tax regime. Dealing with this problem can quickly become extremely complicated.

The Tax Code's Complexity

Simplification is perhaps the most misrepresented issue in the debate about tax reform. Surveys have indicated that taxpayers would support the elimination of all tax breaks; at the same time, however, polls also show that people would object to the withdrawal of the homeowners' mortgage-interest deduction or to loss of the charitable deduction.

Taxpayers' complaints about the complexity of the current income tax may derive less from their own experiences than from impressions about their neighbors' use of the tax code. Roughly two-thirds of all tax filers did not claim itemized deductions in 1982, and almost 40 percent used a short form. At the same time, the number of taxpayers who turned to professional tax preparers increased to 40 percent.

Taxpayers' concerns about complexity may be motivated by the wish to discover what loopholes might have been overlooked. This concern is reinforced by the numerous special-purpose provisions in the tax code for which most tax filers are ineligible. But even with the IRS's ingenuity in designing relatively simple tax forms, the complexity of tax law makes it almost impossible for filers to divine from the forms what the underlying law really is. For example, filers using tax tables to determine their liabilities cannot easily tell what tax rate brackets they are in. Not knowing why one has a certain tax liability has to be frustrating.

Diminished tax evasion is another argument made for simplification. The multitude of tax preferences available today may encourage ineligible persons to seek tax avoidance in other ways. Elimination of special provisions might give the impression of a more equitable system, making lower tax rates possible and compliance more attractive. The result could draw income from the "underground economy" into the taxed mainstream. But because so little is known about the underground economy—precisely because it is underground—how much income that now goes unreported (aside from income at or below the zero-bracket amount) would be claimed is unclear. For policymakers to rely on this phenomenon as a major source of additional federal tax revenue would seem imprudent, however.

Fairness

An often discussed but fairly elusive aspect of tax proposals is their "fairness." (I should point out that at least two of the better-known tax-reform plans include the word "fair" as part of their titles.) Equity is very subjective, however. What may appear to be an equitable arrangement to one taxpayer may seem wholly unjust to another.

The everchanging notion of how progressive the current tax code should be is evidence enough of this fact. Studies of the income tax code have shown that its distributional effects have fluctuated. Over the years, the combination of legislative changes and inflation-induced bracket creep have made the tax system more progressive during some periods and have moved it in the opposite direction during others.

Motivated by efforts to accommodate concerns about distributional effects, many of the tax-reform plans circulating through the Congress highlight the fact that their effects on the distribution of tax burdens by major income groups change only slightly from current law. Any significant reform, however, will radically influence the distribution of tax burdens among income groups. Reform could also result in capital losses on assets losing special tax privileges and attendant gains for other capital assets. The prospect of such adjustment problems has been a major factor impeding reform in the past. But I should note that, if we can enact a tax system that is truly efficient, a net gain in the value of all assets that grows over time should follow.

CONCLUSION

As the income tax laws grow more complex, the case for tax reform gains strength. That the current level of federal revenues could be achieved with greater efficiency, simplicity, and fairness seems clear.

But reform in itself can cause problems, with some big winners and big losers both from changes in the taxation of income flows and from the capital gains and losses that those changes induce. The current system is so complex that predictions of who those winners and losers stand to be in the short and long run is impossible. But to the extent that a more efficient and equitable system can be designed, the pains of the transition period can be eased by the fact that society as a whole will be a net winner.

Senator GORTON. We have now been joined by Senator Evans. We would be delighted to have him either up here at the table or to make a statement, if he has one and cannot stay long. Why do you not come up and join us?

Senator EVANS. Mr. Chairman, I would be delighted to make a statement. Unfortunately, I cannot stay with you very long. So, it is your choice as to where. I think maybe here.

Senator GORTON. Why not sit down there then [referring to witness table] and make a statement.

OPENING STATEMENT OF SENATOR EVANS

Senator EVANS. Unfortunately, as my colleague well knows, you cannot return home without being dragooned into almost anything and everything that is necessary to do.

I am delighted, however, to appear here very briefly to welcome my colleague from Minnesota, Mr. Durenberger, to have him visit the Northwest and see the delights of this part of the country, which matches at least the delights of Minnesota, and to appear before my colleague. He would have been disappointed—and I suspect others in this State—would have been disappointed as well—if I was not attracted like flies to honey when the subject was tax reform.

If Senator Durenberger is not aware, I spent most of the 12 years as Governor attempting to institute tax reform here in the State of Washington—unsuccessfully, I might add. But that 12-year attempt was to broaden, to simplify, to gain better productivity out of a tax system which, in this State, has been and increasingly is narrow, unproductive, and inequitable. And the goals we sought were those simply of equity in so far as you can adequately measure equity, breadth so that you are not focusing too much on one small element of the public, and productivity, producing sufficient money for the essential characteristics of government.

At that time I felt that in the State of Washington it required the institution of an income tax, and very quickly I became known as the firm advocate of an income tax as a fundamental philosophy; and that simply was not true. If I had at the same time been Governor of the State of Oregon—which has a broadly based income tax, but no sales tax—I would have just as avidly sought a sales tax in order to reduce the burdens of the very high income tax they have in Oregon for the same goals of equity and breadth and productivity.

FIRST STEP ON DEFICIT REDUCTION COMPLETED

So, now I appear before this panel to apparently go in the opposite direction of my history of 12 years to institute an income tax, this time to suggest the need to simplify and reduce rates for most people at least on a national income tax. The focus for this last few months in Congress has been on the deficit and on a deficit-reduction package. Congress has just completed a successful first step, and admittedly it is just that, a first step on deficit reduction. But a major element of that was bits and pieces of new taxes or changed taxes or even reduced taxes encompassed in a bill more than 1,000 pages in length—honestly not understood in its entirety by perhaps any Member of the Senate. It is one difficult for anyone to fully understand. Fortunately, there were enough people who understood enough of the elements to make a reasonable decision, I think. But it is symptomatic that it takes 1,000 pages for relatively minor changes in our Federal income tax system that we have a creaky, rickety structure, which is really on the verge of collapse.

As we look at the problem of tax reform, I think that we approach it gingerly because it is an awesome task. It is an awesome task because it is so large, but it is an urgent task because it is so necessary. We have taken some important first steps. The tax rate reductions of the last several years have helped to reduce some of the burdens of taxation on people. Tax indexing, which Senator Gorton has been so instrumental in helping initiate, will soon take effect, unless it is delayed. And tax indexing corrects one of the strangest abberations I think in our tax system, the opportunity for Congress to gain more money for spending without passing any increase in tax rates. Tax indexing will correct that. It is also admittedly going to create some new problems for Congress. The requirement that if spending increases, new taxes will have to be initiated or current taxes deliberately raised. But the fundamental change is still necessary.

And I think the elements of those, as I see them, are to do several things, among the many which have been suggested. First, to carry the concept of indexation one step further from indexing of tax rates to the very important indexing of exemptions, to ensure that we retain the same exemptions—personal exemptions and for family members—at the value they once had. And, as I recollect, the $600 exemptions of 30 years ago, if indexed during intervening time, would approximate $4,000 today and would make a vastly different tax system with vastly different consequences on individuals and families than now exists. And I think it is important that if we are going to index, we index through our tax code.

MINIMIZING DEDUCTIONS IMPORTANT

I think it is important in a new and simplified structure to minimize deductions. And I guess if I were to come down on behalf of one or another of the many proposals now in front of Congress, it would be on behalf of those which are broadest in coverage, with the least major exemptions and, as a result, with the lowest tax rates.

I admit I get into some considerable difficulty, starting right at home, with that proposal. My wife has long been associated with charitable organizations, particularly with the Seattle Symphony, for many years and indicates that if there were no charitable deductions, it would be difficult to gain the money necessary to run many of these charitable organizations. And my suggestion to her that people would have more money in their pocket and would be able to make charitable contributions of their choice and still have more money left in their pocket did not seem to make much of an impression. She said: "But, no, what they really want to give for is the tax advantage."

I said, "Well, that is not all there is to it, I hope."

But, nonetheless, it represents a pervasive view and one perhaps difficult to overcome. The same thing is likely true in the long-held importance of deductions for home mortgages. And that may well be an important deduction to consider. But, as was pointed out in the testimony just a few minutes ago, a pretty high percentage of people do not even use the itemization. I suspect that a good many people with home mortgages that are of any age no longer use itemization because the value of that interest is not sufficient to mean very much to them. So, that too is a big item, but one I think ought to be considered as whether viable under a new broadened and simplified Tax Code.

To the degree you can minimize those large exemptions, you can set rates so much lower and still raise sufficient revenue that it seems to me that ought to be the goal. If we are going to do the job, a major job, it ought to be done as well as we can do it. And the result, as I have said, is to put money back in people's pockets from which they can make their own choices as to charitable contributions, as to investment in homes, as to all of the other things they would do not from special exemptions in a Tax Code, but because they have the money after taxes to accomplish those purposes.

TAX CODE SHOULD ENCOURAGE INVESTMENT

It seems to me that another important element of any major change in our Tax Code ought to be in the direction that would encourage investment and—I think concurrent with that—encourage savings which can lead to investment. And at question here is whether any holding period ought to be necessary on capital gains or whether even with a new tax system a capital gains tax at all is necessary if the overall taxes have been reduced so much that you could levelize taxes on capital as well as on earnings.

I think it is awfully important for us in Congress, as well as people on the outside, looking at a Tax Code to not get too hung up on political philosophy, particularly partisan political philosophy. Perhaps in 1985, when in the cycle of election there is maximum political courage immediately after a Presidential election, is the time to put some of that partisan political philosophy behind us and get at the task of major tax reform. No better time for the next 4 years than to do it or initiate the effort in 1985.

The transition, of course, is another element of major importance. The transition cannot be abrupt, and some considerable thought ought to be given to an appropriate transition period, perhaps even a phase-in of a new system which occurred over a several-year period, with a portion of it gradually coming into effect over that several-year period.

MEASURE OF TAX VALIDITY

Finally, the measure of tax validity, I suspect, may well be in the number of pages involved in the statute books themselves. I took the trouble to look through our own State of Washington tax code. The sales tax, simple, straightforward, takes 19 pages of the code. Our business and occupation tax, another excise tax, also incidentally takes 19 pages of our code. The property tax, perhaps the most subjective and least objective and most difficult to manage of all of our tax systems, takes 145 pages of the code, which is a clear indication of its difficulty. And I suspect that if we were to look at the Federal Tax Code, we would find just how difficult Federal income taxes become by the number of pages it takes in our Federal code.

We simply need to move to a system more understandable to our citizens and, of course, finally the very same goals that we sought in the State of Washington, that of equity, of breadth in coverage, and of productivity, which we all need. Thank you, Mr. Chairman.

Senator GORTON. Thank you very much, Senator. We appreciate your being here with us.

A question for Dr. Penner. I listened with due care to your presentation. When you got to the proposition we might well consider changing to a consumption based tax system, I do not think I heard a recommendation other than that it be considered. Did you put yourself squarely on the side of a consumption-based tax system from a policy standpoint?

Dr. PENNER. No, sir. CBO always puts itself on both sides of that kind of issue, Senator.

Senator GORTON. That is my memory.

Dr. PENNER. Yes.

RESOLVE PHILOSOPHICAL DISPUTE FIRST

Senator GORTON. But a query on that: What are the primary justifications for a consumption-based system as opposed to an incomes system? Obviously one of them is it is presumed in fact on savings and investment. Are there others of equal weight? And among economists how strong is the consensus that a consumption tax would in fact significantly increase savings and investment?

Dr. PENNER. In judging whether the income or consumption should be the basis of taxation, I think first you really have to resolve a philosophical dispute. And that dispute goes back to Hobbes at least, who asked: Is it fair to tax people's contribution to society, as crudely measured by their income, or what they withdraw from society, which is crudely measured by their consumption? Clearly, he was very much on the side of a consumption tax.

But I think that our own philosophy has placed great emphasis on something called ability to pay, which is not an easy thing to measure. But through the years there has been broad support of economic income as a good measure of ability to pay. Some of the strongest advocates of a consumption tax would even dispute that. They would say that ability to pay depends not only on income but also on wealth, on the variability of income, and on a lot of other things—and that a person's consumption is not in fact a bad measure of his or her own assessment of ability to pay. But of course, you get some difficult cases. A person who is unemployed, for example, keeps up a consumption stream at a certain level. He can hardly avoid it. Is it really fair to tax such people?

I find it interesting that the two most prominent proposals for tax reform put before the Congress so far have put themselves very firmly in the camp of the income tax. I am thinking of course of Bradley-Gephardt and of Kemp-Kasten. They have not moved toward a consumption tax, with the possible exception of their proposed treatment of IRA's.

First of all, as to whether there is an academic consensus in favor of consumption as a base: I think one has to say no, although it is at least interesting that on both sides of the Atlantic in the late 1970's, the Meade Commission in the United Kingdom and the Blueprints for Tax Reform issued by Secretary Simon here both favored expenditure taxes. They have been favored by people as diverse in their political beliefs as William Simon and as Nicholas Kaldor, a prominent British socialist economist. On the other hand, some giants in the public finance profession in this country are firmly against it. I think of Joseph Pechman of the Brookings Institution, and Richard Musgrave recently of Harvard. And yet other people at Brookings recently came out firmly in favor of expenditure tax. So, I guess I cannot say there is a consensus. I think the real dispute is philosophical.

CONSUMPTION TAX WOULD HAVE NO HUGE EFFECT ON SAVINGS

Your particular question on the effect on savings—again not a consensus there, although I think I see the economics profession moving more and more toward predicting positive, though not huge effects from reducing the taxation of savings. One of the more prominent estimates is that of Michael Boskin from Stanford. He would estimate that a 1 percent increase in the after-tax return to savings would increase savings by 0.4 percent. That is the sort of order of magnitude we are talking about.

Senator **Gorton**. Let me ask you for a comment on something you mentioned briefly in passing and Senator Evans devoted more prominence to in his comments. And that is the relation between an income tax and inflation. Do you believe that the indexing accomplished in 1981 was in fact a tax reform, a justified tax reform? Should the whole question be revisited, or in fact should it be extended, either as Senator Evans indicated or as I understand is sometimes proposed, to adjust the income tax to the cost of living in different States in different communities across the country, which varies relatively widely. Where does indexing, in other words, stand with respect to this drive for tax reform?

INDEXING OF TAX RATE STRUCTURE EXTREMELY IMPORTANT TAX REFORM

Dr. **Penner**. First of all, the indexing of the tax rate structure—which the Congress did in 1981, effective in 1985—is an extremely important tax reform. Though prior to indexing—during the period of what has turned out to be the United States greatest inflation in history, from the late 1960's to the present, the Congress did offset the macroeconomic effects of the absence of indexing on the Tax Code. But they did it in a way that I would suggest can be better characterized as using the profits from inflation, from bracket creep, to reform the tax system. That is to say, throughout the long period from the late 1960's to the late 1970's we had all these tax cuts that kept the aggregate burden the same, but they were devoted mainly to increasing standard deduction, and to some degree increasing the exemptions. In other words, the cuts focused on the lower half of the income distribution, while the upper middle class drifted into higher and higher tax brackets through that whole period. Not until 1978, really, did we give them some relief.

In the late 1970's, the bracket creep was allowed to prevail, raising overall tax burdens. We reversed that with the cuts in 1981. So, we are really not far from the personal income tax rate, on average, that we had in the middle 1960's right now even though it has been offset. What I am trying to say is that indexing is a very important reform, because while Congress cannot really be accused of letting inflation raise tax burdens, they could be accused of using it to perform a silent kind of tax reform. It may not have been a bad tax reform. I am not saying it was bad or good. I am just saying that it took place without intense debate because you in essence had the profits of inflation to play with.

As I noted in my full testimony, indexing the tax rate structure is a very different thing from correcting the other problem that inflation causes; namely, distortion of the tax base. In noting the problems with depreciation, capital gains, and so on in my discussion of the consumption tax, I should have noted that a committee in the United Kingdom that advocated consumption taxes did so in large part because the United Kingdom does not suffer this problem. They essentially just threw up their hands and said, "It is impossible to deal with inflation and capital income for the purposes of the tax law; let us just not tax capital income." That was one of their main arguments. And, in fact, it would be extraordinarily difficult to handle. However, if we remain in the confines of the present system and think of expanding indexing, I would suggest working on that problem long before worrying about trying to adjust for differentials between States and so on.

Senator GORTON. Senator Durenberger?

MORE REVENUES NEEDED

Senator DURENBERGER. Maybe just one question. We could keep each of these witnesses here all afternoon, I am sure. But I wonder, Rudy, if you would not react with some dimension to what I heard as a conclusion, I think, in the chairman's opening statement, and that was something to the effect that we very much need the additional revenue from tax reform to close the deficit. I wonder if you could give us just a little picture over the last perhaps 3 or 4 years and then head it into the next 3 years of what the total Federal revenue compared to Federal spending has been, and then perhaps your own conclusions, which I assume you can deal with in your capacity as to whether or not it is even feasible in the next 2 or 3 years to look to equal parts of spending reform and tax reform in order to get us closer to balancing the budget.

Dr. PENNER. I do not have all the numbers you want with me. As I noted before, however, we kept the overall tax burdens essentially constant from the late 1960's, when we had the uptake with the Vietnam war, and then we had a downward trend around the 18- to 19- percent level of GNP. Not until late in the seventies—I forget whether it was 1979 or 1980—did the overall tax burden go over 20 percent of the GNP. Soon after, it was brought down to 18.6 percent in 1983. And under the tax law before the bill you all just passed, it remains constant, going roughly up to 18.9 by 1989. This bill adds a bit to that, though I do not have the exact number with me; the addition is constant through time. That is to say, it is not a wedge that will grow and grow over time. In fact, the addition is almost constant in absolute terms—so, therefore, less of addition relative to GNP over time.

Meanwhile, outlays have continued to grow, reaching 24.7 percent of GNP in fiscal year 1983. That was very much affected by the recession. But under CBO's own baseline assumptions—again this is before the changes you just made—which involved 5 percent real growth in defense spending over the period, there is actually an upward drift. After going down a bit, it gets up to 24.9 percent in 1989.

As to the question, "Can you close the gap entirely from the expenditure side?" I think the whole argument over deficits involves what role Government should play in our society, and the decision about how much you take out of spending is, of course, largely a philosophical one. But I think you would agree that, over the last year, we have seen a wide consensus develop in the Congress that something has to be done on both sides.

To me, the most important fact which sheds light on this budget situation is that under the laws as they existed earlier this year, CBO's projections of defense, social security, medicare, and net interest on the debt—which, as you know, is growing like gangbusters—would absorb more than 95 percent of the revenues we had projected under the prior law for 1987. The budget resolutions as they exist in the Senate and the House do change this picture to some degree. We had projected a deficit equal to 5.4 percent of the GNP for 1987. If you took something in between the resolutions passed by the two Houses, that would knock a full 1 percentage point of the GNP out of that deficit, bringing it down—depending on where you came out at the end—to something over 4 percent. That is a big policy change. The downpayment was a significant thing, but not nearly enough.

So, the bottom line is, yes, I think we all agree on a need for more revenues. But there is still enormous discussion about how much. That depends crucially on what you do to the big absorbers of money I mentioned—defense, Social Security, medicare.

RAISING REVENUES BY BROADENING TAX BASE HAS POTENTIAL

I think there is a further agreement we are not really going to cut the nondefense discretionary program by much any more. They have borne the brunt of the cuts that we have had so far. So, how much you need depends crucially on just how much change occurs in those big programs I mentioned. And, of course, as everybody knows, they are all very popular politically.

As for the scope or the possibility of raising revenues—say, by broadening the tax base—there is a lot of potential there. I am just looking for some of the numbers. But it depends critically on this savings investment thing. A lot of the things we call "loopholes" are really encouragements to saving and investment, one way or another. And that goes back to what I referred to in my full testimony as an ambiguity as to whether we really want to tax income or consumption.

But the very biggest single item on my list of so-called tax expenditures is the revenue lost from the net exclusion of pension contributions—$57.6 billion. Deductibility of mortgage interest on owner occupied homes, at $27.9 billion, is No. 2 on my list. Deductibility of nonbusiness State and local taxes, other than property taxes, is $21.8. billion In your area of specialty, exclusion of employer contributions for medical insurance premiums is No. 4 on my list, at $21.3 billion. Accelerated depreciation on property, $18.3, billion is and so on. In other words, there is an enormous amount of money there. But how much of it you want to tax is again a philosophical problem.

CONCENTRATE ON SHORT- AND LONG-TERM NARROWING OF BUDGET

Senator **Durenberger**. I am just trying to get a sort of quick bottom line, as you view this process. I mean, you can look at Social Security, pensions, medicare, et cetera. All those are income-security related, and they are a huge part of the Federal budget. And you do not even have to look at it politically to know that if we are going to make reform in those areas, it is all going to be long-range reform and it is going to have minimal impact on the deficit. And I would guess that you could come to similar conclusions, at least in the short term relative to the cost of acquiring money to fill the deficit as well. And would that not suggest to us that in a budget context this particular subject—tax reform—is probably the most important area in which we could concentrate our societal efforts over the next 2 years on the effort of somewhat coming to grips with both a short- and a long-term narrowing of the deficit. And whether it is reforming the existing tax or switching in some way to an alternative national tax that with *x* number of ounces of energy in the political system, it really probably ought to be put in on the subject of this hearing.

Dr. **Penner**. It used to be a political cliche that you could not reform taxes without having a tax cut of some sort on that. In other words, you could not use it to raise revenues, as you are suggesting. Or at least, we have never been able to reform the tax system under those circumstances. It is perhaps conceivable that the pressure for revenues that you have described make it easier. I do not know.

Senator **Gorton**. Thank you. Thank you very much, Rudy.

Thank you, Senator. We appreciate your being here.

Our next panel will consist of Roland Hjorth and John Makin.

And I think we will proceed with the two of you in alphabetical order and listen to what each of you has to say before we ask questions of either of you.

Professor **Hjorth**. My name begins with H.

Mr. **Makin**. That does it. You are first.

STATEMENT OF ROLAND HJORTH, PROFESSOR OF LAW, UNIVERSITY OF WASHINGTON

Professor **Hjorth**. Thank you very much. I appreciate the chance to be here. I have submitted a short written statement.

Senator GORTON. We will include the statement as if read in full.[1]

Professor HJORTH. I would like to make an even briefer written statement. I think if I had revised this thing, I might not be here at all today.

I also would like to welcome Senator Durenberger to the State from Minnesota. I grew up in the State of Nebraska, in the northeastern part, and we used to think of Minnesota as God's country, especially my father did. And I thought so too until I came out here. And we certainly welcome you here.

Senator DURENBERGER. I have been impressed this weekend myself.

TAX INCENTIVES MUST BE CONFRONTED

Professor HJORTH. I would like to consider very briefly whether it is wise to use the tax laws to use nontax goals. I refer to these laws as tax incentive provisions. In the context of our existing tax system, we have already used tax incentives to such an extent, I think, that we have almost converted the income tax to a consumption tax. That is, if we view income as the sum of all consumption, plus all savings, and if we consider a tax incentive as a kind of exemption or exclusion designed to favor a given kind of savings or a given kind of consumption, there are very few kinds of savings expenditures left that we can encourage in our existing tax system.

Further tax incentives are, however, touted by some persons as alternatives to direct government programs. Tax incentives are an issue in our present system. They will continue to be an issue in two principal modified forms of tax reform, the consumption tax and the flat-rate income tax. In fact, adoption of either system would require us to reassess our attitudes about the use of tax incentives.

The consumption tax exempts all kinds of savings from tax. Under a consumption tax it would appear to be difficult to favor one kind of savings over another. But it would only appear to be difficult. We could still grant a credit against the consumption tax base, against consumption itself, for a favored kind of savings expenditure. It would of course be possible to favor one kind of consumption over another, continue to grant deduction for home mortgage interest, that kind of thing.

A flat-rate tax on a broad base on income—that is to say, on both consumption and savings—I suppose is not supposed to utilize tax incentives. But I believe that pressures to utilize tax incentives, even within the context of a flat-rate tax, would very, very soon emerge, and we would see them beginning almost immediately.

Therefore, we must confront the issue of tax incentives, no matter what form of basic tax structure we choose, if we intend to alter the structure that we now have.

AVOID TAX INCENTIVES

And very briefly, as I state in more detail in my statement, I believe tax incentives should be avoided in any new form of tax.

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[1] See p. 32.

There are too many tax incentives in our present tax. They probably cannot be removed. But we should look at any tax incentive proposal, in my opinion, with skepticism. I oppose them for at least the following reasons. They are, as many people have said before, subsidy programs. And the subsidies usually go to those who need them least.

Second, they are hidden. The surest way to hide a government expenditure Program is to buy that program in the Tax Code. Americans are aware of the Food Stamp program. They are aware of rent-supplement programs. And they are certainly aware of farm subsidy programs. But they are not aware of tax subsidy programs. Not even tax students, not even law students, I should say—the ones that I confront at the law school—are aware that there are direct subsidies through the Tax Code.

TAX INCENTIVES DISTORT A FREE-MARKET ECONOMY

Third, I think that tax incentives distort a free-market economy. They do so to a considerable extent because they are worth more to some taxpayers than they are to others. We might consider an example from Washington State. The example that I think of involves apple orchards. The costs of developing apple orchards can by and large be deducted even though those costs give rise to capital assets having a long life. The outlays are usually savings outlays of one sort or another. But we grant a deduction nonetheless for historical reasons or tax policy reasons—not tax policy reasons, but for some reason.

In any event, irrigation equipment yields a 10-percent investment tax credit, and it can be depreciated over a period of slightly more than 4 years. We might say that that grants a benefit to the apple farmer. But I do not think that it really does. These tax benefits appear to benefit the apple farmer. But they usually generate a larger bracket for the high-bracket taxpayer, for the high-bracket off-the-farm investor. If the off-the-farm investor gets a bigger tax benefit than does the farmer from these tax provisions, then it stands to reason that we have created a kind of unfair competition in favor of off-the-farm investors. And I think that perhaps sometimes these tax incentives actually make it more difficult for the apple orchard farmer to own his own farm.

I think we could say the same thing about the commercial fishermen. I think we could say the same thing perhaps about the person who manages property as a trade or business. Those are not the people who own those assets.

So, I say these things only as examples to show that we do not know exactly how tax incentives work to distort the economy. We think that they grant benefits—and probably they do. But we do not know precisely where those benefits go.

TAX INCENTIVES MAKE LAWS MORE COMPLEX

Fourth, I think tax incentives make our tax laws more complex. Many persons have said the complexity of the income tax law may well lead to its own demise. So many persons have said that that I do not wish to elaborate that point here. But I think that we must face up to this fact. Tax incentives are by far and away the greatest cause of complexity in our Tax Code. We will never have a simple income tax as long as we intend to use the tax laws to foster social and economic goals other than the raising of revenue. We cannot have it both ways. We cannot have a simple income tax or even one that is fairly manageable if we are going to continue to use tax incentives to expand them within the existing system.

And then, fifth, I think that tax incentives create a disrespect for the law. We have always been proud in this country of our system of self-enforcement. We compared our system with that which prevails in Europe, and we have been proud with the degree of tax compliance that we have enjoyed. But we have seen that erode markedly in very recent years. A tremendous portion of the burden of the tax court is taken up in dealing with frivolous tax-shelter cases and in dealing with tax protester cases. Why would that be so? I think it is because of this. The average taxpayer may not realize that incentives are Government subsidy programs. He or she merely thinks of them as loopholes. It almost always requires money to take advantage of tax incentives, and taxpayers know that. Taxpayers without money think that taxpayers with money pay no tax, even though that is not true. Some affluent taxpayers who see other taxpayers pay few or no taxes are seduced into preposterous tax-shelter schemes that clog our courts and lead to inevitable heartbreak on the part of taxpayers.

Either the investor who takes advantage of tax incentives I think—at least those that are more egregious than others—nor the person who does or cannot take advantage of them has any real respect for tax incentives as such.

For all these reasons, I think that tax incentives should be avoided wherever possible. We will never be able to eliminate them within the context of our existing tax. But in the context of a new consumption type tax or flat-rate income tax we can eliminate a lot of them. And we should certainly attempt to eliminate those that do not have deep historical roots. Thank you.

Senator GORTON. Thank you.

[The prepared statement of Professor Hjorth follows:]

PREPARED STATEMENT OF ROLAND HJORTH, PROFESSOR OF LAW, UNIVERSITY OF WASHINGTON

Using Tax Laws to Accomplish Social or Economic Goals

It is generally assumed that our Federal income tax is a progressive or graduated tax on net income, and that income consists of the sum of consumption plus savings. Recent proposals for overall reform seem to be of two different tyes. The first type is a progressive tax on consumption only. That is, all savings would be taken out of the tax base, but consumption would be taxed at graduated rates. The second type is a so-called flat--or relatively flat--rate tax on a very broad base. The flat rate tax would presumably tax both consumption and savings, and would tax many elements of savings that are not now taxed.

My own preference is for a graduated tax on consumption--largely because we have used tax incentives to accomplish social and economic goals to such an extent that the taxation of savings income is little more than a way of regulating economic activity.

I do not intend to speak directly to either type of tax proposal. I wish rather to consider if it makes any sense, whether in our existing system, in a consumption tax system, or in a flat rate tax system, to use tax laws for non-tax purposes. For convenience, I refer to tax law provisions designed to accomplish social or economic goals as "tax incentives." These tax incentives usually work by taking preferred expenditures out of the tax base by means of exclusions from gross income or deductions from gross income.

Consumption Type Income Tax. It is often assumed that it would not be possible to use tax incentives within the context of a consumption-type income tax. Certainly it would be more difficult to do so. Tax provisions in our present system that are designed to accomplish economic or social goals usually do so by exempting certain kinds of savings from tax. If *all* savings are exempted, no particular kind of savings can be encouraged over other kinds. It would not be possible to use tax laws, for example, to encourage private pension and profit sharing plans because the tax benefits now granted to qualified plans and their beneficiaries would be available to any person who chooses to save instead of to spend. Tax incentives would nevertheless be possible. Certain types of consumption could be preferred over other types of consumption by granting special tax credits or deductions for favored consumption expenditures. One could continue to encourage home ownership within the context of a consumption type income tax by continuing to grant a deduction for home mortgage interest payments. Even certain types of savings could be encouraged by granting credits for certain investments. For example:

> (1) One might wish, in the context of a consumption tax, to grant tax incentives for research and development. That is done now by allowing current deductions for research and development costs even though those costs are in

the nature of capital outlays--that is, they result in savings.

The existing incentive would not work in a consumption-type tax, because all non-consumption type expenditures would be deductible. Research and development could not be favored by means of a special deduction.

It would still be possible, however, to encourage such expenses by granting a credit against the consumption tax for preferred investment activities. The taxpayer who spends $10,000 for research and development might thus be granted a credit of 10% of that amount against his or her consumption tax liability.

(2) The tax preference now granted to state and local bonds would be gone in a "pure" consumption tax. But a consumption tax need not be pure. We could continue to grant tax preferences to state and local bonds by exempting such interest even from a consumption tax base or by including theinterest in the base but by granting special credits against the consumption tax base for the preferred income.

Flat-Rate Type Income Tax. Using tax laws for non-tax purposes is inconsistent with a flat rate income tax if we believe that income can be accurately defined and that the rate should in fact be flat. Granting special deductions or credits for preferred expenditures or income means that the true rate is no longer a flat rate. Persons who incur the preferred expenditures or receive the preferred income would pay less than the nominal "flat" rate of tax. But tax incentives could very easily be included with a so-called flat rate system even though it would be theoretically inconsistent to do so. The inconsistency would be no greater than the inconsistency that now exists. We have a tax that is nominally progressive but that is in fact much more of a "flat rate" tax than is implied by the basic tax rates. Granting tax exemptions and deductions might be less effective if the flat rate is a lower rate, but credits could be used to create any kind of benefits we want. In our present tax system, for example, the basic investment tax credit is 10%. In a flat rate tax system the basic tax credit could be continued, and might even be increased to 20% to make up for the fact--or claim--that depreciation allowances are less valuable in a flat rate tax system and that different incentives are needed.

Tax Incentives a Continuing Problem. The issue of whether tax laws should be used to accomplish social or economic goals is thus an important one, whether we consider the issue in light of (i) our present tax; (ii) a consumption tax; or (iii) a flat rate tax. I believe tax incentives amount to graduated subsidies that distort a free market economy, make our tax laws hopelessly complex, and breed a general disrespect for the tax system. It may not be possible to repeal very many tax incentives within our existing system, but the urge to adopt even more tax incentives should be resisted. Moreover, in the context of a new tax system, whether a consumption type tax or a flat rate tax, we should work to eliminate as many tax incentives as possible.

Tax Incentives as Graduated Subsidies. Some advocates of tax expenditure programs state or imply that these programs cost no money at all. I doubt whether any person here would intentionally so state or imply. We might disagree as to which tax provisions are tax subsidies, but we all acknowledge that some are. It is difficult for me to comprehend, for example, how any person could argue seriously that the recently defeated proposal relating to Enterprise Zones was not a subsidy program that would have been carried out through our tax laws. Also, I think we would agree that most credits listed in section 44 through section 44H of the Code are tax subsidies. Other examples of tax subsidies are listed in Code section 57, relating to the minimum tax.

Tax subsidies are already listed in a tax expenditure budget published each year. The weaknesses of tax incentives as devices for implementing Government policy have been explored elsewhere (Surrey, Tax Incentives as Device for Implementing Government Policy: A Comparison with Direct Government Expenditure, 83 Harv. L. Rev. 705). I do not wish to repeat those arguments, but instead to add some concerns of my own.

1. Tax Incentive Programs are "Hidden" Expenditures. I believe tax incentives should be avoided for the very reason that some persons find them attractive: they are "hidden" subsidies. It is, in my view, not generally good policy to choose programs that citizens do not understand. Citizens understand that a rent supplement program is a Government subsidy. It is less obvious to citizens--assuming they even know about them--that tax exempt mortgage subsidy bonds are also a Government subsidy program. Government programs that are carried out through the Internal Revenue Code are by their nature "hidden" programs. Even law students consider tax law to be a mystery. The surest way to hide a program is to bury it in the Internal Revenue Code. Even if a program so hidden is unearthed, one can almost always argue that it is not a subsidy program at all by arguing that the subsidy merely enables the taxpayer to keep something that always was intrinsically his or hers to keep prior to confiscation.

2. Tax Subsidies Distort a Free Market Economy. Tax incentives can work to bring about a state of unfair competition. Perhaps I can illustrate the distortion by an example;

> Assume that a fishing boat costs $1,000,000 and has a useful life of 20 years. If we wished to measure income accurately we would allow the purchaser of the boat to deduct the cost of the boat over 20 years, perhaps at the rate of $50,000 per year.

> Instead, present law grants the purchaser a tax credit of $100,000 and allows that person to deduct $950,000 over a period of just over four years

These provisions might be considered to be tax incentives. They encourage investment in capital equipment.

The incentives have different values to different people, however. The immediate tax credit, and the ability to deduct $950,000 over a period of slightly more than four years would create the kind of deferral that would be extremely valuable to an executive or professional person with substantial amounts of income otherwise taxed at 50%. Taxes in the first year could be reduced by more than $171,000 because of the tax credit and depreciation allowance. The provisions are of far less value to a fisherman who has no income from sources other than fishing. They could not have a value greater than his tax liability without the provisions. Thus the tax benefit to him is considerably smaller than the tax benefit to the executive-investor. If the tax benefits are more significant to the executive than to the fisherman, and they usually are, then the tax laws encourage the executive to become the owner and the fisherman to become lessee of the boat. Tax laws should not encourage a separation of ownership from operation. These distortions occur to such an extent that the greatest regulator of economic activity in our country may be the Federal income tax laws. Every equipment leasing tax shelter, cattle breeding tax shelter, real estate limited partnership, and similar venture, illustrates the economic distortion created by tax incentives.

3. Tax Incentives Make the Tax Law Complex. If we add the capital gain deduction to our list of tax incentives, then such incentives are the greatest single cause of complexity in our tax laws. If the sole purpose of the tax law were to define taxable income in a rational way and to impose a tax on that rational tax base, simplification would be an attainable goal. But it is totally unreasonable to expect any simplification if we are unwilling to reduce the number of tax incentives that exist in the Code. The complexity of our Federal income tax may well contribute to its own demise. Federal tax law has become so complex that very few, if any, persons could claim to be experts in all its areas. Complexity is not always inherently bad if there is sufficient specialization and sub-specialization to make the system work, but certainly complexity is no virtue.

Many other persons have bemoaned the complexity of the income tax and I do not intend to elaborate their arguments. But it is clear that we cannot have it both ways: if we intend to adopt more tax incentives our tax laws will become more complex.

4. Tax Incentives Create Disrespect for the Law. We have always been proud of our record of voluntary compliance with the Federal tax laws, especially when we compare our system with systems prevailing in other countries. Compliance is becoming a much more serious problem. A very substantial portion of the case load of the Tax Court consists of cases involving so-called abusive tax shelters and various forms of tax

protest. It would be worthwhile to study the extent of respect or disrespect for our tax system and the causes of that disrespect. I suspect that we would find that respect for our Federal tax system is declining to an alarming degree. One cause of that disrespect by many middle and lower income tax payers is, I suspect, their perception that the tax system is unfair. They perceive it to be unfair because they perceive that persons with substantial wealth or income pay little or no tax. The perceived underpayment may be attributable to what observers call loopholes but what in fact are tax incentives. In truth, there are very few loopholes. There are many tax incentives perceived to be loopholes, and they will be with us as long as we consciously choose to use the Federal income laws to achieve social and economic goals.

Conclusion

An income tax system can sustain only a limited number of tax incentives. At some point, tax incentives begin to distort the tax base to such an extent that the tax bears no relationship to its name. Our tax system cannot sustain more tax incentives. Any structural reform of our system should work toward the elimination of tax incentives to the maximum extent possible.

Senator GORTON. Mr. Makin.

STATEMENT OF JOHN H. MAKIN, DIRECTOR, INSTITUTE FOR ECONOMIC RESEARCH, UNIVERSITY OF WASHINGTON

Mr. MAKIN. Thank you, Mr. Chairman. I am something of a neophyte in the area of fiscal policy, coming to it from a concern with the behavior of financial markets and some of the concerns that our allies abroad have expressed with the level of interest rates in the United States. So, I will largely confine myself to my written remarks and expand on them a little bit in light of some of the comments that have gone thus far.

FEDERAL TAX REFORM SHOULD HAVE THREE GOALS

There should be three goals for Federal tax reform in 1985. Simplification and stabilization of the Tax Code, aimed at providing households and corporations with more predictable and more understandable tax rules. Second, enhancement of sustained capital formation as a basis for sustained growth of the economy and with it sustained growth of job opportunities. Three, purging the Tax Code of inflationary bias.

The first two goals require positive action. The third requires only retention of indexation for income tax exemptions and rate brackets already scheduled to begin in 1985 under the terms of ERTA. And Mr. Penner discussed these, and I think Senator Evans discussed these as well. I think, Senator Gorton, you raised the question with Rudy Penner of whether we should open the question of indexation again. While I mention it here, I would just interject that I think opening the question of indexation would cause many in the financial markets to think that the probability of accelerated inflation would be higher simply because the question was being opened and the possibility of returning to indexation, which has the unattractive feature of tying tax revenues to the rate of inflation, would raise considerable concern and, given the rate of interest rates that we see now—further upward pressure on interest rates—would be something we might want to avoid.

Returning to the text here, the goals of simplification and enhancement of capital formation are well served by a move toward more straightforward consumption-based taxes like those outlined in the U.S. Treasury's bulletin for basic tax reform that was prepared in 1977 under Secretary Simon by David Bradford and an able staff. Presumably the Treasury is paying some attention to the plueprint as it prepares for the President its tax-reform proposals due in December. The basic idea of this approach is to add all saving to the list of normal deductions, an extension of the idea already embodied in IRA, Keogh, SRA, and other retirement accounts.

A value-added tax also represents a form of consumption tax widely employed in Europe where food, housing, and other necessities are usually exempt. VAT is often proposed for its revenue-generating potential, which is estimated at $10 to $12 billion per percent levied on all consumer items, so that a 5-percent VAT would yield something on the order of $60 billion a year in revenues. Tempting.

VAT also is recommended as a consumption-based rather than an income-based tax. My own preference is for the deductible savings approach over VAT on the basis of its specific encouragement of saving, something that I will mention later on as a high priority for the American economy.

Tax reform cannot proceed without addressing the continuing need to deal with revenue considerations and the large fiscal deficits that are projected for the rest of the 1980's. While progress on the downpayment is laudable, more needs to be done, if we are to judge by the tepid reaction of the financial markets to its near enactment as well as by the large deficits still in the offing. Tax reform aimed at sustained capital formation is the least painful way out of the current deficit conundrum. In my view, tax reform and the need to address the deficit problem are inextricably bound together.

ADDRESS THE ISSUE OF CAPITAL FORMATION

Let me give a little background on why I feel that we need to address the issue of capital formation as we address tax reform and the deficit problem.

The postwar trend of American capital formation and growth has been downward. In 1949, the first year of an early postwar American recovery, output grew at an annual rate of over 16 percent—that is, real output—while productivity of the labor force grew at about 7½ percent. In 1983, the first year of a 1980's style recovery, the 16-percent growth rate of real output had dropped to just under 5 percent. And the 7½ percent growth of productivity had dropped to about one-third of it, or 2½ percent.

Looking at savings and investment from 1946 to 1950, American net private saving averaged 7.6 percent of gross national product. Total net investment averaged 9.6 percent of GNP, with 8.2 percent of GNP coming from domestic sources and the rest coming from abroad.

In other words, investment was growing and the capital was coming in from abroad.

The Federal Government's budget surplus was 2.6 percent of GNP. By 1983, net private saving had fallen to 5.1 percent of GNP—which, as we remember, is about where the deficit lies—while total net investment had fallen even more sharply to 1 percent of GNP, 1.6 percent from domestic sources and minus 0.6 percent from abroad. In other words, the source of funding was no longer from abroad; the general level of saving and capital formation as a share of total economic activity had dropped considerably.

At the same time, the Federal Government's budget deficit had risen to a postwar high of 5.4 percent of GNP, slightly more than enough to consume all private saving. In short, large inflows of capital from abroad were and still are required to make up the shortfall between private saving and fiscal deficits.

I think I may skip the next paragraph and just go ahead and talk a little bit about some of the more current issues.

EPISODIC TAX BREAKS PRODUCE TEMPORARY EFFECTS

It may be said by some that generous provisions for accelerated depreciation and investment tax credits under the ERTA-TEFRA legislation have removed the need for further attention to capital formation in the Tax Code. Nothing could be further from the truth. As extensive research on past Tax Code changes has shown, such provisions as ERTA and TEFRA and accelerated depreciation and investment tax credit produce only a temporary stimulus to capital formation which peaks about 2 years after enactment. In effect, ERTA-TEFRA has provided a temporary antidote to the negative impact on capital formation of high real interest rates. That antidote, which has kept investment and growth far stronger than expected—at least by economists—during the first half of 1984 will begin to wear off by the end of the year. If real interest rates remain high, as they very likely will given the current prospect of about $1.2 trillion in deficits between fiscal 1985 and 1989, the negative impact on capital formation and on the recovery will be devastating.

The basic message here is to aim at a Tax Code that contains stable, ongoing inducement to capital formation rather than episodic tax breaks. There have been 14 corporate tax reforms since 1954. Such episodic tax breaks produce only temporary effects and serve to accentuate the volatility of investment in economic activity. Consumption-based taxes set at a flat level sufficient to generate revenues needed for essential Government programs—I realize that phrase is a major fudge—are the best means to make the Tax Code more simple and predictable while enhancing capital formation.

Let me just add an aside here on the complexity of the Tax Code. Rudy Penner reported on household attitudes toward complex tax codes and on the resources that corporations have to devote to the tax code. I think that it is not so much the complexity per se that is the problem. It is the fact that every time the rules change, another 1,000 pages comes out which has to be digested, but added to that is the possibility that whenever a household or a corporation is doing their planning, they usually have to plan conditional on some major tax reform that is currently under discussion. And the outcome of the plans could be severely affected by the outcome of the debate on tax reform. One of the things that I think is important to consider is really the impact of uncertainty on households and corporations. And where you are steadily tinkering with a fairly complex document like the tax code, the uncertainty effect could be considerable—is considerable I think.

STABILIZE RATIO OF NATIONAL DEBT TO GNP

Continuing on, to try to identify a goal here which pulls together some of the discussion of deficits and tax reform, progress toward tax reform and control of deficits requires a clear approximate goal. I think that goal ought to be stabilization of the ratio of national debt to GNP, the capacity to carry debt. We should stabilize the ratio of national debt to GNP at its current level of about 40 percent. The reason for this is that higher levels frequently degenerate rapidly into far higher ratios and eventually runaway inflation. Parenthetically, the U.S. ratio reached 107 percent after

World War II, but then interest rates on T-bills were below one-half of 1 percent, and the interest burden was relatively small. And that ratio fell quite rapidly to a level of 25 percent in 1974. Since 1974 it has risen rapidly back up to a current level of about 40 or 41 percent.

For purposes of comparison, I dug around and found that the average debt-to-GNP ratio in the EEC in 1981 was about 42 percent. And we can discuss the reasons for picking that number later on.

To stabilize U.S. debt to GNP at 40 percent by 1989 will require reduction by about $660 billion of the currently projected $1.2 trillion of 1985 to 1989 deficits. And here I am using CBO numbers. They are predown payment CBO numbers. The reason I am using them, if we factor in the effect of higher interest rates that we have already got on that and project interest rates over the next couple of years, they are enough to wipe out most of the deficit-reducing gains that are in the down payment. So, I use approximately the same number; obviously projections over a 5-year period are nothing more than that.

A 5-YEAR PROJECTION OF $660 BILLION IS A SIGNIFICANT PROBLEM

This was an exercise that I did just to ask myself how significant a problem is a $660 billion 5-year deficit. In a word, it is a very significant problem if we put it in terms of the expenditure cuts that might be considered drastic that one could look at and then ask what is left over on the revenue side.

Suppose we consider major spending cuts in terms of their CBO-projected impact on the 1985 to 1989 cumulative deficit. Illustrative propsals include a 3-percent stable floor on growth of overall National defense spending through the end of 1994. The effect between 1985 and 1989 would be about $178 billion. Setting COLA's on nonmeans tested programs at two-thirds of CPI growth would be about $54 billion. Stabilization of agricultural commodity price supports, about $41 billion. Limiting growth of nondefense discretionary spending to 2 percent a year, in real terms about $63 billion in savings. Index interest on long-term bonds, which I think the Treasury ought seriously to consider—the saving would be $12.85 billion.

These fairly drastic proposals yield total 1985 to 1989 spending reductions of about $350 billion. That leaves another $310 billion to get on the revenue side.

REPEAL OF INDEXATION IS OPPOSED

Calculations such as these lead one to consider some fairly drastic measures on the revenue side. If the measures are to be concentrated on consumption, they become even more burdensome to many lower-income households. CBO estimates that about $60 billion could come from a 5-percent value added tax. Even more tempting in terms of its revenue potential is repeal of indexing, which would yield an estimated $6 billion in 1985. But that annual yield would rise to an estimated $65 billion in 1989. And of course that is conditional on the inflation forecast by the CBO. That with its inflationary impact would enhance even further the tax windfall from repeal of indexing since the revenue yield of that repeal rises with inflation.

And I have already gone over my reasons for opposing the repeal of indexation. Retaining indexation leaves a serious revenue gap even given radical spending cuts outlined above. But real economic growth provides the major source of relief. Enhanced capital formation can help to move real GNP growth to the CBO's high-growth path. Solid action to reduce deficits and thereby demands on capital markets, together with tax reform aimed at encouragement of saving, will lower real interest rates. These actions, together with lower and more predictable inflation, will help to produce a sustained increase in capital formation.

If the CBO high-growth path were achieved, 1985–89 deficits fall by an estimated $390 billion which, together with $270 billion in spending cuts—that is a hundred billion less than the cuts outlined above—would achieve the requisite $660 billion cut in the 1985 to 1989 deficit. Remember the $660 billion is needed only to stabilize the ratio of debt to GNP at 40 percent. We are not getting rid of deficits. We are simply stabilizing that burden.

FOLLOW POLICIES TO ENHANCE ECONOMIC GROWTH

In closing, I just want to say the important thing to remember in approaching tax reform and action on deficits is that the least painful way to reduce deficits is by following policies designed to enhance economic growth. And the best way to enhance growth is by encouraging investment. A simpler and more stable tax code which taxes consumption instead of savings, together with action on the deficit that cuts real interest rates without tying revenues positively to higher inflation, can combine to return the American economy to a stable, noninflationary growth path that generates more job opportunities for a growing labor force. Thank you.

Senator GORTON. Thank you.

Mr. Hjorth, I was fascinated by your statement on social policies and the Tax Code. Let us reduce it to some specifics. Some fairly popular ways that we use the Tax Code now for various social policies are exempting the interest on State and local government obligations from Federal taxation, allowing the deduction of adoption expenses from Federal income taxation. We help working mothers by allowing for the deduction of certain child-care expenses. And of course perhaps the most fundamental of all, we promote home ownership by allowing mortgage interest expenses to be deducted. Would you advocate eliminating any or all of these deductions? And, if you do, would you promote some alternative direct expenditure way of reaching those social goals?

Professor HJORTH. If I can take the four that you mentioned, I would consider child-care expenses probably proper deductions in computing income. If I consider income to be the sum of savings and consumption, it can be argued that those are not ordinary and necessary business expenses, and the Tax Court so held at one time. But one could also say that looking at working parents, a deduction for child care is a deduction to enable them to work and properly deductible in computing what we might consider an ideal tax base. So, I would take that one out.

The others that you mention, two of them are historical. They have been with us almost from the time that we adopted the Income Tax Code. And I did say of course it would be difficult to remove those that have a long history. But taking them up and considering adoption expenses, it really does not seem to me very sensible at all to grant a deduction for adoption expenses. If we want to eliminate the cost of adopting a child or to reduce the cost of adopting a child, unless we want to encourage adoption of children by those that are well to do—and maybe that is what we want to do—but we should know that is what we are doing because deductibility of adoption expenses does not do any good to people whose incomes or whose other deductions do not give them much of a benefit. But deducting costs of adoption expenses gives 50-cents-on-the-dollar relief to those who are in very high tax brackets. So, it falls unevenly.

Senator **GORTON**. Of course the same thing is true with both of the other historical deductions, is it not?

Professor **HJORTH**. Home ownership and State and local bonds.

Senator **GORTON**. Home ownership, but quite a number of people do not get any effective use out of that deduction, do they?

DEDUCTION FOR HOME MORTGAGE INTEREST NOT SENSIBLE HOUSING POLICY

Professor **HJORTH**. That is true. I would suppose that there is some belief that interest expense is intrinsically deductible. I have never understood quite why that should be so. And I do not think it would be reasonable to advocate successfully repeal of the deduction for home mortgage interest. But if you are asking me about it as a tax matter, I also do not think that it is leading to great complexity in the Tax Code and that kind of thing. But I would think that it is not a very sensible housing policy. In the first place, it is deductible only to the extent that it, with all other itemized deductions of a taxpayer, exceeds the zero bracket amount. And that means that for a family of four, their zero bracket amount is $3,400. They cannot deduct anything from their home mortgage interest except to the extent that it exceeds that, together with other deductions. And this zero bracket amount has the effect of diluting the value of all of these deductions, these itemized deductions, and it makes them even more regressive in their effect. That is, people with huge mortgages can deduct almost all of it. The deduction will be larger. The tax benefit per dollar expended will be larger. And the diluting effect of the zero bracket amount will be smallest.

So, it does not seem to me to be sensible as a housing policy to do that. And if we consider this, home mortgage interest expense is deductible, State and local property taxes are deductible. If a principal residence is sold and one moves into one that costs at least as much as the old one—and it must cost at least as much as the old one—then the capital gains tax is forgiven. And if people keep doing this until they are 55, then they can move down and have $125,000 excluded. And that may seem all very good and sensible, and I am not an economist. I only know that those benefits are there. But I have often wondered what the effects of all those provisions are upon the costs of homes. It may appear that those provisions benefit homeowners, and perhaps they do. But certainly they don't benefit people with small mortgages, people who have paid off their mortgages. They may benefit people with small mortgages, but not as much as people with large mortgages. But I would assume that there is no such thing as a free lunch and that they must have some effect on the cost of houses. So, I would say if we want to have a housing program, we should consider that as a housing program. And if we think it is good, then fine. But it should be considered in that light.

THERE ARE OTHER WAYS OF AIDING STATES AND LOCALITIES

Then going to State and local bonds, there have been many proposals that we eliminate the exemption and replace it with other kind of direct relief. There are people whose opinions I respect very much. Mr. Ellis from the city of Seattle—Jim Ellis disagrees with me on this entirely. And he thinks that using State and local bonds are means by which we improve our neighborhoods and our localities and local governments. And I respect his opinion a great deal. I disagree with it, however, because it has led not only to the exemption of State and local bonds. We do that. Then somebody hit upon the happy idea of having port districts and other local governments borrow money and turn it over to industry. It is a good way of getting industry into the locality.

Then we thought that that is too blatant, a giving away of a tax benefit to industry. So, then we decided we do not want to let that happen if it is too much. So, we should limit it to a certain dollar amount per county and per locality. So, you can do that. And then maybe it is a good idea if we permit people to do it for pollution control and other desired forms. And we have seen section 103—which is the tax-exempt provision of the code—turn from a very, very simple provision—it was understandable by almost everyone—to a provision of about 30 pages in the code and 150 pages in the regulations. It is a provision not comprehensible to anyone other than a municipal bond tax expert. I do not believe that I am a competent municipal bond tax expert though I devote my entire professional career to the study of taxes. So, I think that if we want to aid States and localities, this is a way of doing it. There are other ways of doing it, and I would prefer the other ways.

Senator **DURENBERGER**. Maybe I will ask this question of both of you because I think the whole issue of exemption of what relates in some way to the issue that Mr. Makin covered on page 4 of his prepared statement,[1] when he subscribes to us the notion that we ought to settle for a national debt of 40 percent of our GNP. And it illustrates for me the constant frustration that I have in coming to grips with what debt is. I mean, everybody out there thinks debt is the national debt. They do not think about the credit cards in their pocket and all the rest of this stuff. And the national debt today is somewhere in the neighborhood of $6 or $6½ trillion, and yet we never hear that spoken of as part of the national debt. I am not sure we can deal adequately with the subject of tax reform without coming to grips in some way with the notion of what tax policy has done for debt in this country. And you just fixed on one of the fun ones, which is the interest deduction. I mean, there is no tax on consumption in America today. I mean, the whole incentive is consumption. And, yes, Hobbes told us that maybe that was something we needed to do in America, and we did it for 30 years. And we pulled the whole world or half the world up by putting the accent on consumption. But we do now have a different kind of problem, which is the fix in effect that we have ourselves into with the size of the debt and our ability to repay it.

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[1] See p. 54.

Just one interesting little figure that comes from, in effect, from CBO, and it comes before the last increase in the prime rate. The total increase in debt just in last year and this year that the two of us brought to America—I don't know what it amounted to, $180 billion one year and $190 billion the next, something like that—the cost to repay that over 30 years for each $1 of new debt, the cost of repayment is 128 bucks. That I think has an impact on the economy. I think it has an impact on our kids and a whole lot of other things.

So, it seems to me that there is an element when we look at the deduction side and when we look at all of this, there is a larger element of debt, debt service, the capital formation issue that you address that somehow we need to look at a little bit more explicitly. And if either of you have any reactions to that, I would appreciate it.

INTEREST DEDUCTION CONTRIBUTES TO COST OF CAPITAL GOODS

Professor HJORTH. If you talk about private debt, it has seemed to me that deducting private debt very often enables people to deduct what is in essence a capital cost in this sense. Our interest rate on debt takes into account inflation, and the dollars that we ultimately pay on the original debt are worth far less than the dollars that we originally borrowed, so that someone who purchases land, borrows money to buy land, for example, and eventually prepays it years later down the road will pay a very high interest rate, but a large part of that interest rate is attributable to inflation. It is built into the interest rate. So that really we are enabling people to deduct what is in essence the cost of buying property. And I often wondered how much that costs us, for example. It has seemed to me we do not tax unrealized appreciation on the other side. That is to say, if you buy land, borrow money to buy the land, the interest is deductible. If everything works out right, the land rises in value. We deduct the interest. We do not report the gain from the land until we sell it. And that is true of home mortgage interest. It is true of almost any kind of interest that is paid. And, so, there is actually a tax incentive to borrow money by making it deductible. And that is not limited to home mortgage interest, in fact. It is equally applicable, in my opinion, to money borrowed to buy real estate. And it is of course behind virtually every tax shelter, legitimate or otherwise, that is being sold on the market today. If we took away the interest deduction and limited it to what it really costs, I do not think we would have any tax shelters. And I do not know how much money is lost. I assume it is a tremendous amount. I think that the existing deduction though has to contribute to the cost of capital goods, the dollar value.

U.S. TAX POLICY OUT OF LINE WITH WORLD ECONOMY

Mr. MAKIN. First of all, in my testimony I did not mean to suggest that 40 percent is an optimal ratio. I meant to suggest it was a modest goal. It would still be hard to achieve. But I think the issue of American tax treatment of interest income and expense is one that I have looked at over the past 3 or 4 years. One of the guidelines of experience that we have is, of course, treatment of interest income and expense in other major industrial countries where it is considerably less liberal on the side of subsidizing consumption. And one of the problems that we have today is the problem that where we have the effect of inflation on interest rates, plus taxes, compounded, it means that in order to slow down the economy, we have to drive nominal interest rates to 15 or 16 percent in the United States. This of course, where the United States is becoming a more and more integral part of the rest of the world, creates some very serious problems. We are draining capital out of Europe, creating considerable hardship there. When we look at the stock of debt that the LDC's are dealing with now, we basically have an imminent default on our hands because they simply cannot bear the burden of interest rates that are determined in markets where everyone gets to deduct it from their taxes. In Brazil it does not mean anything to Brazil that General Motors or Mr. Jones can pay 15 percent to buy his car because he can deduct the interest from his taxes. Brazil still has to pay the market rate, but it is in no way deductible for them.

So, when we think about the United States in the world economy, this is a question where our tax policy is really out of line.

INTERGENERATIONAL TRANSFER LIKELY

One comment on the issue of home ownership and the interest deductibility of home ownership. One of my first studies when I go onboard in Washington at AEI is going to be to commission a study where we ask: What would be the after-tax monthly cost for an average American to buy an average-priced American house if we allowed no deductibility of interest for any consumption purpose and we did not tax any interest on savings?

First of all, there would be a drop in interest rates. But the major effect would be on—as Professor Hjorth suggests—the value of the house. And what you would have would be a big transfer from people who have a lot of housing stock to people who do not. The irony is that it would be very likely more affordable for the young Americans so favored by those who talk about this issue to afford a house after the price of the housing stock had dropped. You would have what we economists call intergenerational transfer from old to young, which probably would also have a measurable positive effect on the saving rate since the young tend to save more than—sorry, wrong way around—a negative effect. But you would have a big intergenerational transfer. That would be the big effect. And that is why if you talk about the program, you have got to—as in many others—you have got to talk about phasing it in gradually or else there will be a major effect on the ownership of wealth in this country. But those are the effects. And as to whether or not when you took into account the drop in the value of the housing stock, which is now presently a very good tax shelter, and the negative effect on interest rates, you might find that monthly payments on a $90,000 house would be less than they are now.

Senator GORTON. Thank you very, very much. We really appreciate your help with this. Outstanding.

[The prepared statement of Mr. Makin follows:]

STATEMENT OF JOHN H. MAKIN, DIRECTOR, INSTITUTE FOR ECONOMIC RESEARCH, UNIVERSITY OF WASHINGTON

First, let me express my thanks to Senator Gorton and members of the committee present for providing me with an opportunity to address the Senate Budget Committee on federal tax reform. Views expressed are my own and should not be attributed to any institutions with which I am associated.

There should be three goals for federal tax reform in 1985: (1) simplification and stabilization of the tax code aimed at providing households and corporations with more predictable and more understandable tax rules; (2) enhancement of sustained capital formation as a basis for sustained growth of the economy and with it, sustained growth of job opportunities; and (3) purging the tax code of inflationary bias. The first two goals require positive action. The third requires only retention of indexation for income tax exemptions and rate brackets already scheduled to begin in 1985 under terms of ERTA.

The goals of simplification and enhancement of capital formation are well served by a move toward more straight forward consumption-based taxes like those outlined in the U.S. Treasury's *Blueprints for Basic Tax Reform* prepared in 1977 by David Bradford and an able staff. Presumably the Treasury is paying some attention to the Blueprint as it prepares for the President its tax reform proposals due in December. The basic idea of this approach is to add all saving to the list of normal deductions, an extension of the idea already embodied in IRA, Keogh, SRA and other retirement accounts.

A value added tax also represents a form of consumption tax widely employed in Europe where food, housing and other necessities are usually exempt. VAT is often proposed for its revenue generating potential which is estimated at $10 - 12 billion per percent levied on half of all consumer items. VAT also is recommended as a consumption-based rather than an income-based tax.

My own preference is for the deductible savings approach over VAT on the basis of its specific encouragement of saving, something that I will mention later on as a high priority for American economic policy.

Tax reform cannot proceed without addressing the continued need to deal with revenue considerations and the large fiscal deficits that are projected for the rest of the 1980's. While progress on the 'down payment' is laudable more needs to be done if we are to judge by the tepid reaction of the financial markets to its near enactment as well as by the large deficits still in the offing. Tax reform aimed at sustained capital formation is the least painful way out of the current deficit conundrum. In my view tax reform and the need to address the deficit problem are inextricably bound together.

The postwar trend of American capital formation and growth has been downward. In 1949, the first year of an early postwar American recovery, output grew at an annual rate of over 16 percent while productivity of the labor force grew at about 7.5 percent. In 1983, the first year of a 1980's-style recovery, the 16 percent growth rate had dropped to just under 5 percent and the 7.5 percent growth of productivity had dropped to about 2.5 percent. From 1946-50 American net private saving averaged 7.6 percent of Gross National Product (GNP). Total net investment averaged 9.6 percent of GNP with 8.2 percent of GNP coming from domestic sources and 1.4 percent coming from abroad. The federal government's budget surplus was 2.6 percent of GNP. By 1983 net private saving had fallen to 5.1 percent of GNP while total net investment had fallen even more sharply to 1.0 percent of GNP, 1.6 percent from domestic sources and minus 0.6 percent from abroad. The federal government s budget deficit had risen to a postwar high of 5.4 percent of GNP, slightly more than enough to consume all private saving. In short, large inflows of capital from abroad were--and still are--required to make up the shortfall between private saving and the fiscal deficit.

These figures in no way capture the broad sweep of postwar American economic experience but they do suggest a trend, particularly noticeable since 1980 though present throughout much of the almost 40 year period since the end of World War II. American capital formation is slowing and the primary result is less resilient and shorter economic recoveries as measured by the level of output and productivity growth. Growth of employment opportunities has consequently atrophied. During the 1950-54 period the unemployment rate averaged 3.9 percent. It averaged 8.4 percent from 1980 to 1983. Jobs have not grown as fast as the labor force. An increasingly unfavorable climate for investment, particularly long term investment crucial to maintenance of American competitiveness worldwide, has resulted in a slowing of capital formation that has in turn translated into slower growth of jobs. At least in facing this problem, the interests of labor and capital are complementary, not contradictory.

It may be said by some that generous provisions for accelerated depreciation and investment tax credits under ERTA-TEFRA have removed the need for further attention to capital formation in the tax code. Nothing could be further from the truth. As extensive research on past tax code changes has shown, such provisions produce only a temporary stimulus to capital formation which peaks about two years after enactment. In effect, ERTA-TEFRA has provided a temporary antidote to the negative impact on capital formation of high real interest rates. That antidote which has kept investment and growth far stronger than expected during the first half of 1984 will begin to wear off by the end of the year. If real interest rates remain high, as they very likely will given the current prospect of about $1.2 trillion in deficits from fiscal 1985 to 1989, the negative impact on capital formation and on the recovery will be devastating.

The basic message here is to aim at a tax code that contains stable, ongoing inducement to capital formation rather than episodic tax breaks (there have been fourteen corporate tax reforms since 1954) which produce only temporary effects and serve to accentuate volatility of investment and economic activity. Consumption based taxes set at a flat level sufficient to generate revenues needed for essential government programs are the best means to make the tax code more simple and predictable while enhancing capital formation.

Progress toward tax reform and control of deficits requires a clear proximate goal. Stabilization of the ratio of the national debt to GNP (the capacity to carry debt) is an appropriate one. We should stabilize the ratio of national debt to GNP at its current level of about 40 percent. Higher levels frequently degenerate rapidly into far higher ratios and eventual runaway inflation. (The U.S. ratio reached 107 percent after World War II when interest rates on T-bills were below one half of one percent and the interest burden was relatively small but fell rapidly to a low of about 25 percent in 1974. The average debt to GNP ratio for EEC countries in 1981 was 42 percent.)

To stabilize U.S. debt to GNP at 40 percent by 1989 will require reduction by $660 billion of the currently projected $1.2 trillion in 1985-89 deficits. [The $1.2 trillion already includes the $50 billion 'down payment' on the deficit with the effect of higher than projected 1984-85 interest rates factored in.]

How difficult will it be to achieve a $660 billion 1985-89 deficit cut. In a word, very. First, suppose we consider major spending cuts in terms of their (CBO) projected impact on the 1985-89 cumulative deficit. Illustrative proposals include (estimated 1985-89 deficit reductions in parentheses): a 3 percent stable floor on growth of overall national defense spending through the end of 1994 ($177.7 billion); setting COLA's (cost of living adjustments) on non means tested programs at two-thirds of CPI growth ($53.3 billion); stabilization of agricultural commodity price supports ($40.95 billion); limiting growth of non-defense discretionary spending to 2 percent per year ($63 billion); indexing interest on long term bonds (given CBO interest rate projections) ($12.85 billion).

These fairly drastic proposals yield total 1985-89 spending reductions of $348 billion. Reduction of projected 1985-89 deficits by $660 billion to attain 40 percent debt to GNP ratio would require 1985-89 tax increases totaling $312 billion given this set of proposed spending reductions.

Calculations such as these lead one to consider some fairly drastic measures on the revenue side. If the measures are to be concentrated on consumption they become even more burdensome to many lower income households. CBO estimates that about $60 billion could come from a 5 percent value added tax. Even more tempting is the repeal of indexing which would yield an estimated $6 billion in 1985 and $65 billion in 1989. VAT with its inflationary impact would enhance even further the tax windfall from repeal of indexing since the revenue yield of that repeal rises with inflation.

It is for the very reason just stated--that the revenue yield of an unindexed tax system rises with inflation--that I am opposed to repeal of indexation. The negative experience of American households and firms with the tax code and inflation is well known. The secular downward trend in output and productivity growth results in excessive use of monetary stimulus to prolong the recovery phase of a business cycle. The result is accelerating inflation that pushes households into higher tax brackets via bracket creep and lower after-tax profits for corporations due to the decreased real value of depreciation allowances and nominal inventory profits that arise from the U.S. tax code. The negative impact of the latter on U.S. capital formation has been extensively studied and documented by Martin Feldstein and other investigators at the National Bureau of Economic Research. Eventually, Congress reacts with tax reform for corporations and 'tax cuts' for individuals that do no more than stabilize the household tax burden after bracket creep has already enhanced the tax take. Representative Barber Conable (R-N.Y.) estimates that the 'bulk' of the increase in Federal revenues from $116 billion to $690 billion during his 20 years in Congress through 1984, came from bracket creep. That same period saw five major 'tax cuts.'

Retaining indexation leaves a serious revenue gap, even given radical spending cuts outlined above. But real economic growth provides the major source of relief. Enhanced capital formation can help to move real GNP growth to the CBO's 'high growth' path. Solid action to reduce deficits and thereby, demands on capital markets together with tax reform aimed at encouragement of saving will lower real interest rates. These actions together with lower and more predictable inflation will help to produce a sustained increase in capital formation. The CBO 'high growth' path would reduce 1985-89 deficits by an estimated $390 billion which together with $270 billion in spending cuts (almost $100 billion less than cuts listed above) could achieve the requisite $660 billion cut in the 1985-89 deficit.

The important thing to remember in approaching tax reform and action on deficits is that the least painful way to reduce deficits is by following policies designed to enhance economic growth and the best way to enhance growth is by encouraging investment. A simpler and more stable tax code which taxes consumption instead of saving together with action on the deficit that cuts real interest rates without tying revenues positively to higher inflation can combine to return the American economy to a stable noninflationary growth path that generates more job opportunities for a growing labor force.

Senator GORTON. We now have a panel of Gladys Burns and Larry Kenney. Ms. Burns is under a very real time problem and, so, we will hear from her first; and if we have any questions, ask them first. But, Mr. Kenney, why not come on up to the table, Larry?

Ms. BURNS. I do not know who I have been speaking to, but I have told my story to her (indicating reporter).

Mr. KENNEY. Tell it again, Gladys.

STATEMENT OF GLADYS BURNS, DIRECTOR, PEOPLE FOR FAIR TAXES

Ms. BURNS. OK. I am Gladys Burns, and I live in Olympia. And my experience with people who concern themselves with tax issues fall into four groups. And we heard them here today. People who design and administer tax systems, the bureaucrats and the politicians. People who are primarily concerned about how taxation is affecting them personally: What is it going to do to me? A growing number of accountants and lawyers who make their living by guiding clients through the tax maze. And people in academia who study tax systems for the purpose of understanding the uses of taxes and the ways that they function.

I do not fit into any of those. I am one of a group of people, nonprofessional, nonpaid, who are students of tax systems simply because they are a basic part of government at the Federal, State, and local levels and because we find them intensely interesting. I am not a director of People for Fair Taxes. I was a founder of People for Fair Taxes, which is a coalition of organizations and individuals in the State of Washington which are attempting to—we prayed for Governor Evans' intentions many years back, and we still do.

The ideas that I want to share with your committee today about needed reforms in the tax system have been shaped primarily from information that I have received from the Citizens for Tax Justice, which is a national citizen-labor coalition, headquartered in Washington, DC, 2020 K Street, Northwest. And I respectfully suggest that you and your staff in your study of these issues familiarize yourself with this organization, if you have not done so already.

TAX SYSTEM BEING USED TO ACHIEVE OTHER OBJECTIVES

In every discussion of these issues, I think we have to remind ourselves that the primary purpose of any tax system is to raise revenue to defray the costs of Government.

The fact that the Federal tax code is this bewildering 15,000 pages of deductions and exemptions and credits is evidence that the system is being used to achieve many other objectives. We have talked about them here today, the principal one being the provision of means of tax avoidance for people who have over the years succeeded in getting policies changed for their particular benefit. And my next line is underlined. Their interest in the consequences of these changes to the structure or function of the tax system as a whole has clearly been lacking.

The manipulation of the tax system to create such tax concessions distorts investment patterns and uses up the talents of a growing number of professional people. In fact, practitioners in this new growth industry have even been able to identify within the tax code provisions by which individuals can make money, at Government expense, by losing money. I find this absurd and objectionable.

I believe that changes must move in the direction of restoring the basis of corporate and personal income tax rather than adding new types of taxes. I am moving on to this other subject.

Many ideas have been advanced, and we hear these again. The flat-rate national sales tax, the value-added tax. Both, to my thinking, are morally unacceptable because it would be impossible to implement in any way that would not be regressive.

Personal expenditure tax would reduce the impact of taxation on people with money in excess of their basic needs and would place the largest proportion of tax responsibility on young people who are having to borrow to acquire property and possessions and for old people who are drawing down their savings for living expenses.

Either of these proposals would pick people whose total income is so small that they have little or nothing to say and are in a disadvantaged position.

The people who would benefit from such systems are those wealthy enough to own capital, the income from which would be effectively sheltered.

SIMPLE AND FAIR TAX SYSTEM FAVORED

As a means of achieving the goals I consider desirable, I favor in general the approach taken by Senators Bradley and Gephardt as a way to make the tax system both simple and more fair. They are suggesting a few. And in general the ones are the allowable deductions which they judge would provide greatest benefit for people in the $15,000 to $30,000 income range.

They also recommend that taxable income, however defined, should be taxed at a flat rate as a means of further simplification. I take exception at that point.

In reality, the application of a rate—either flat or graduated—does very little to complicate the system. What people find hard to understand is that the complexity occurs in the base on which the tax is computed. It is not in the application of the rate, either flat or graduated. Since different kinds of income are taxed differently, the equity which existed in early versions of the tax code has been drastically eroded.

As I was sitting here I just thought it would be interesting to go back to the early tax code and see what that looked like before this process of "termitization" began on the system and the utilization of the tax system for intentions for which it really was not designed, the design being to raise the necessary money in a fair and equitable way for the money that the Government needs. I am not going to give an example here.

PRIMARY CRITERION IS EQUITY OF TAX RESPONSIBILITY

In summary, I have said that changes in the tax system must move in the direction of correcting the major distortions in our present system of income taxation rather than attempting to shift to any other form of tax based on consumption.

I am saying that the time for change is long overdue. I hope you will do it. And to remember again that the main purpose of taxes is to generate revenue to defray the costs of Government, which has as its primary criterion equity of tax responsibility among taxpayers.

Senator GORTON. Thank you.

[The prepared statement of Ms. Burns follows:]

STATEMENT OF GLADYS BURNS, DIRECTOR, PEOPLE FOR FAIR TAXES

I appreciate being invited to speak before this committee today.

My experience is that people who concern themselves with tax systems fall into four groups:

1. People who design and administer tax systems--the bureaucrats and the politicians.
2. People who are primarily concerned about how taxation is affecting them personally.
3. A growing number of accountants and lawyers who make their living by guiding clients through the tax law maze.
4. People in academia who study tax systems with the purpose of understanding the purposes they serve and the way they function.

I fit into none of the above.

I am one of a group of people, non-professional and non-paid who are students of tax systems simply because they are a basic part of government at the federal, state and local level and because we find them intensely interesting.

I am a founding member of People For Fair Taxes in Washington, a coalition of organizations and individuals which was formed in 1978 with the sole purpose of advocating changes which will bring more equity and stability into the tax system of our state.

My ideas, which I want to share with your committee today about needed reforms in the federal system have been shaped primarily from information I have received from Citizens For Tax Justice. This is a national Citizen-Labor Coalition headquartered at 2020 K Street, NW, Washington, DC. I respectfully suggest that you and your staff, in your study of tax issues familiarize yourselves with this organization, if you have not already done so.

In every discussion of these issues, I think we must remind ourselves that the primary purpose of any tax system is to raise revenue to defray the costs of government.

The fact that the federal tax code is a bewildering 15,000 page list of deductions, exemptions and credits is evidence that the system is being used to achieve many other objectives, the principal one being the provision of the means of tax avoidance for people who have, over the years, succeeded in getting policies changed for their particular benefit. Their interest in the consequences of these changes to the structure or function of the tax system as a whole has clearly been lacking.

The manipulation of the tax system to create such tax concessions distorts investment patterns and uses up the talents of a growing number of professional people. In fact practitioners in this new growth industry have even been able to identify within the tax code provisions by which individuals can make money, at the expense of the federal government, by losing money.

I find this both absurd and objectionable.

I believe that changes must move in the direction of restoring the bases of the corporate and personal income tax rather than adding new types of taxes.

Many such ideas are being advanced.

1. A flat rate national sales tax, or a value added tax, to my thinking are morally unacceptable because it would be impossible to implement it in a way that would not be regressive.

2. A personal expenditures tax would reduce the impact of taxation on people with money in excess of their basic needs and would place the largest proportion of tax responsibility on young people who are having to borrow to acquire property and possessions, and for old people who are drawing down their savings for living expenses.

Either of these proposals would put people whose total income is so small that they have little of nothing to save are put in a disadvantaged position.

The people who would benefit from such systems are those wealthy enough to own capital the income from which would be effectively sheltered.

As a means of achieving the goals I consider desirable I favor, in general,the approach taken by Senators Bradley and Gephart as a way to make the tax system both more simple and more fair. They propose eliminating a substantial number of provisions in the current code which are essentially tax subsidies. They would keep as allowable deductions only those which they judge would provide greatest benefit for people in $15,000 to $30,000 income range.

They also recommend that taxable income, however defined, should be taxed at a flat rate, as means of further simplification.

I believe this to be a superficially appealing but essentially deceptive proposal.

In reality the application of a rate--either flat or graduated-does very little to complicate the system. What people find very hard to understand is that the complexity occurs in the base on which the tax is computed. Since different kinds of income are presently treated very differently the equity which existed in early versions of the tax code has been drastically eroded.

This is the process which must be reversed.

A person required to pay $100 dollare of tax on a taxable income of $10,000 (1%) is made to assume a far greater burden in relation to his tax paying capacity than a person who is required to pay $1,000 on $100,000 of taxable income. The theory that a single tax rate applies equally to everyone simply does not work out in actuality. Both proportionaly and actually people who are at the lower end of the income scale are disadvantaged.

This fact should also be taken into consideration.

In summary I have said that changes in the tax system must move in the direction of correcting the major distortions in our present system of income taxation rather than attempting to shift to any form of a federal tax based on consumption.

I am also saying that the time for such a change is long overdue. I sincerely hope that the efforts of your committee and other committees in Congress will focus their effort toward the achievement of a tax system whose primary function is to generate revenue to defray the costs of government and which has as its primary criterion ,equity of tax responsibility among taxpayers.

Ms. BURNS. And I have to go.

Senator GORTON. You have no time for questions?

Ms. BURNS. I will answer a question. I will sacrifice my time. Go ahead.

Senator GORTON. I am just going to ask you one since you have in effect said that what is necessary is not a new system, but proper reform of the present system.

Ms. BURNS. That is my belief. I am speaking as an individual.

Senator GORTON. If you could have one druthers, what would the single most important reform in the present system be?

TAX INCENTIVE SYSTEM IS DECEPTIVE

Ms. BURNS. I think I would agree with Professor Hjorth, the matter of the tax incentives. I think that is the most deceptive kind of concept that has moved into the system of any. And then I would go from there to some of the things that I have claimed as distorting the base.

Senator GORTON. Thank you very much, Gladys.

Ms. BURNS. Thank you for having me.

Senator GORTON. It is very nice to have you with us. Larry, thank you for [Mr. Kenney follows:]

Mr. KENNEY. I always step aside for Gladys any time.

Senator GORTON. And you may proceed, and you have a little more time because she took so little.

Ms. BURNS. Maybe there will be other times for conversation.

Senator GORTON. Thank you. There will be.

STATEMENT OF LAWRENCE KENNEY, SECRETARY-TREASURER, WASHINGTON STATE LABOR COUNCIL

Mr. KENNEY. For good or bad, Gladys was one of my mentors on taxes when I started with the labor council years ago.

I have submitted a fairly lengthy statement.

Senator GORTON. We will include that in the record as if read.[1] If you will summarize it, we will have more time for questions.

Mr. KENNEY. Frankly, I think you summarized it as well as anybody when you asked Gladys a question. And she responded probably as well as anybody.

Let me go back to Mr. Durenberger's question earlier about death and its impact. It seems to me that he does hit upon a problem. And one of the problems is the changes in the financial institutions that have occurred over the years either by action of Congress or by the action of financial institutions themselves that have done nothing but increase the demand for money without increasing its supply. And deregulation is only going to make that worse because increased competition for a fixed number of dollars by the financial institutions can only have one impact, and that is to raise interest rates. It is not going to make for a better world for anybody. That has nothing to do with taxes, I guess, but I think that is an issue one has to look at, too.

I am going to take a few sentences out of my testimony.

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[1] See p. 67.

1981 TAX CHANGES PRACTICALLY ELIMINATED CORPORATE INCOME TAX

The 3-year across-the-board cuts in individual income tax rates enacted several years ago were heavily targeted to upper bracket taxpayers. When the effects of inflation and rising Social Security taxes are factored in, the vast majority of middle- and lower-income taxpayers now pay a higher share of their income in taxes than they did 4 years ago. The 1981 changes practically eliminated the corporate income tax as a significant source of Federal tax revenues. The business tax changes not only accentuated the tax shift from corporations to individuals and from the wealthy to the working class, they also increased the already existing distortions in economic decisionmaking. Specifically, the accelerated cost recovery system distorts the allocation of new capital investment, turning some investments with little economic merit into attractive investment opportunities solely because of tax writeoffs.

And as one of the unfortunate participants and unwitting participants of the building of a major downtown condominium, I can assure you that if it were not for the tax system, that baby would be a complete disaster, and there would be at least one bankrupt bank now. But because of the tax system, that bank may be saved.

Years of business tax reductions have reduced the contributions of the corporate income tax to Federal revenues from almost 25 percent in 1960 to about a quarter of that in 1983. But let me point out that the Reagan tax cuts are not entirely without virtue. They serve as a bad example. They prove conclusively that tax inequality and untargeted tax reductions are not the way to increase economic prosperity.

I think the best description of what has happened to tax structure in the last several years was made by David Stockman in the Atlantic Monthly when he said, by God, the hogs were feeding, because they were. And it has reflected itself in the results.

And among the proposed solutions, the so-called flat-rate tax is a hoax. And I do not think that one can say anything more about that.

CONSUMPTION-BASED TAX SYSTEM OPPOSED

And we are opposed to converting to a consumption-based tax system. Consumption-based taxes would fall most heavily on young families and senior citizens who must consume most of their income to survive.

Seven years ago, I married a woman with eight children. That is not to show that I am a brave man, but most of those children are now in the family-forming stages. They range in age from 28 down to the youngest who is 13. But most of them are between the ages of 18 and 28. One of them has been able to buy a new home. And that is the one who just got married last year, who are born savers, and both of them have from the very beginning wanted to save money.

But the plumber with two children cannot buy a home. The ironworker with two children cannot buy a home. The carpenter with two children, he bought a home several years ago in the Tri-Cities in a low market. But the majority of them, I do not know when they are going to be able to buy a home. And if you make mortgage interest nondeductible, I am convinced that unless some other system is developed to help young families, they are not going to be able to buy a home.

TAX SYSTEM NEEDS RESTORATION OF EQUITY

And finally just one more thing. What we need is not a new improved tax system, but simply restoration in some measure of equity and fairness to our current system.

I do not really have anything more to add unless you want to ask something about all this stuff that comes from the AFL-CIO mainly.

Senator GORTON. Thank you.

[The prepared statement of Mr. Kenney follows:]

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STATEMENT OF LAWRENCE KENNEY, SECRETARY-TREASURER WASHINGTON STATE LABOR COUNCIL, AFL-CIO BEFORE THE SENATE BUDGET COMMITTEE ON FEDERAL INCOME TAX REFORM

JULY 9, 1984

Thank you, Mr. Chairman, and committee members. My name is Lawrence Kenney. I am secretary-Treasurer of the Washington State Labor Council, AFL-CIO. The Washington State Labor Council appreciates the opportunity to present its views on ways to improve the federal income tax system.

We believe that reforms to improve the fairness of the federal tax system, reduce the federal deficit and stimulate the economy are essential. We support changes in the federal income tax that will restore the federal tax system to one based on the principle of ability to pay and which will be capable of generating enough revenue to meet the nation's economic, social and defense spending needs.

In recent years United States tax policy has experienced a major shift in direction. But the changes have reduced equity and have provided hardships for those least able to bear additional burdens. The tax changes of 1981 and 1982 have failed to produce the employment and income gains predicted. Instead, they have produced bigger deficits, increased poverty, reduced employment, lowered real earnings for workers, raised interest rates, produced record trade deficits and increased inequality in the distribution of the tax burden.

The tax reductions of 1981 are the largest single contributing factor to the rapid increase in the federal deficit. The 1981 changes have reduced anticipated 1984 receipts by $130 billion, an amount equivalent to three-fourths of the projected deficit. Even after taking into account the subsequent actions by Congress to recoup some of the revenue lost through these changes, some $350 billion, well over half of the projected deficits of the next three years, can be attributed to the 1981 give-aways.

The 1981 changes accelerated the tax shift which is increasing the proportion of taxes paid by middle income taxpayers and decreasing the share of taxes paid by wealthy individuals and corporations. The tax changes were promoted on the basis that even though they might increase inequality over the short term, the benefits of reducing taxes on the wealthy and on corporations would trickle down and benefit all taxpayers. When the results are compared with the promises, the statements made on behalf of the 1981 tax changes represent a colossal deception.

The three-year "across-the-board" cuts in individual tax rates turned out to be across-the-board in name only. They were heavily targeted to upper bracket taxpayers. When the effects of inflation and rising social security taxes are factored in, the vast majority of middle and lower income taxpayers now pay a higher share of their income in taxes than they did in 1980. For example, over the 1982-1984 period taxpayers earning less than $10,000 a year will face real tax increases of 22% compared to 1980. Those making $10,000 to $15,0000 will pay 7% more, and those making $15,000 to $20,000 will face 2% real tax hikes. Families earning $20,000 to $30,000 will just about break even. By contrast, persons making more than $200,000 a year will receive tax cuts during the same period that will average just under $60,000 each. This is more than the total income the average American worker will receive during that period. As a result of the increase in the capital gains exclusions (adopted prior to 1981) and the reduction in the top rate from 70% to 50%, tax rates on capital gains have plummeted. They are now actually lower than the marginal income in the social security tax rate paid by a wage earner with a family of four earning just $12,000. Finally, upper bracket taxpayers will benefit tremendously from the virtual elimination of the estate and gift tax.

The inequities of the 1981 tax changes applied to business as well as individual taxes. 1981 practically eliminated the corporate income tax, a significant source of federal tax revenue. The business tax changes not only accentuated the tax shift from corporations to individuals and from the wealthy to the working class; they also produced distortions in economic decision making. Specificially, the accelerated cost recovery system (ACRS) distorts the allocation of new capital investment, turning some investments with little economic merit into attractive investment opportunities solely because of their tax write-offs. Conversely, they make some good investments unattractive. These distortions were already a problem prior to 1981. The changes adopted then only made them worse.

Years of business tax reductions have reduced the contribution of the corporate income tax to federal revenues from almost 25% in 1960 to about a quarter of that in 1983. Even after adjustment for the 1982 revisions, the corporate income tax will compose less than 10% of federal revenues for the rest of this decade. Reducing corporate income taxes was a policy that had been in existence more than 20 years. It should have been clear that continuing to cut corporate tax rates was not going to produce an economic boom. If that strategy had worked, the economy would not have been in the weak condition that it was in 1980.

The Reagan tax cuts are not entirely without virtue. They serve as a bad example. They prove conclusively that tax inequality and untargeted tax reductions are not the way to increase economic prosperity. The tax changes have had a negative effect on the economy by contributing to the high interest rates which have choked production. In addition, they have raised the value of the dollar and severely aggravated the trade deficit.

Dissatisfaction with the effects of the Reagan tax program, the urgent need to reduce the federal deficit and the desire of those who want still more tax preferences will fuel the tax debate in the future. Proposals for wholesale change in the tax structure include replacing graduated tax rates by a single flat rate tax, adding a value added tax and replacing the income tax with a consumption-based tax. We do not believe that our tax system is so fundamentally defective as to require wholesale change. Nor do we believe that it is politically feasible to make massive changes in the near term. Yet if we are to avoid economic catastrophe, revenues must be raised or we will be faced with a weaker, more unstable economic structure and our fundamental problems will continue to grow and fester.

The so-called flat rate tax is a hoax. It will shift more of the tax burden from the rich to the middle class. For example, the shift in tax liability under an 18% flat rate tax will produce a 125% tax increase for a family earning $10,000 a year and a 33% tax increase for a family earning $30,000. But for families earning more than $200,000 a year, taxes will be reduced 45%. Under almost any variation of the flat rate tax proposal, low and middle income taxpayers will suffer tax increases, while those with higher incomes will enjoy substantial tax cuts.

We are opposed to converting the income tax to a consumption-based tax. The changes would increase tax burdens on low and middle income people and reduce them for those at the top of the economic scale. Consumption-based taxes would fall most heavily on young families and senior citizens who must consume most of their income to survive.

We also oppose the addition of a value added tax. A VAT would be regressive and inflationary. It would adversely affect Washington state which has no income tax and consequently is heavily dependent on excise taxes for a majority of general fund revenues.

Federal income tax reform should contribute to reduction of the federal deficit, be based on the principle of ability to pay and promote job creation. With these criteria in mind, we recommend the following changes:

1. Reduce the rate of increase in defense spending increase. Necessary increases in defense should be paid for with a graduated tax surcharge, not by social program cuts.

2. Limit the third-year of the Reagan tax cut to $700 as a step towards reducing the losses due to the 1981 tax cut. and at the same time provide a stimulus in consumer purchasing power.

3. Repeal the indexation provisions of the 1981 tax act. That will increase revenues by $6.2 billion in fiscal year 1985 and by $16.7 billion the following year. Without indexing, progressive tax rates automatically serve as a contra-cyclical force, moderating excessive demand during inflationary periods and helping to sustain purchasing power during recessions. The ability of government to use discretion in the conduct of tax policy will be severely curtailed by linking tax rates to the rate of inflation. It would make monetary policy an even more dominant factor in the economy.

4. Restore the capital gains exclusion to the 50% level that prevailed before 1979. The exclusion would be phased out over a five year period, beginning in 1985 with adequate protection for homeowners. This would raise nearly $3 billion in fiscal year 1985 and over $5 billion in fiscal year 1986.

5. Restore the estate and gift tax to its former structure to raise $3.7 billion in fiscal year 1985 and $5 billion in fiscal year 1986. When fully effective in 1987, only .3 of 1% of all estates will be subject to estate taxes. The liabilities of these few estates that are taxed will be substantially reduced. Equity considerations require effective taxation of accumulated wealth. The recent array of exemptions of capital from taxation makes this even more urgent.

6. Restore the corporate income tax as a significant source of federal revenue by overhauling the system of deductions and credits governing how businesses writeoff their plants and equipment. The ACRS provisions violate the principles of equity and efficiency.

They have significantly contributed to the federal deficit problem. Despite the huge volume of revenues given away by ACRS, the promised increase in corporate capital investment, economic growth and prosperity has failed to materialize.

7. Restore a portion of lost corporate tax receipts by ending tax subsidies that encourage the overseas operations of United States-based multinational corporations. These preferences have eroded the tax structure, destroyed American jobs, and spurred the export of United States capital, technology and know-how. Specifically, the foreign tax credit should be turned into a deduction. The deferral of federal taxes on foreign income should be repealed. Finally, the United States should repeal the domestic international sales corporation (DISC) program. There is no need to create the new foreign sales corporation (FSC). There is no need for export promotion through tax preferences. The experience with the DISC program demonstrates that tax gimmicks only cost the treasury billions of dollars and have no influence on the nation's trade balance.

8. We should eliminate the practice of deducting, as depreciation allowances, costs that were already deducted as investment credits. Congress went halfway in 1982. If it completes the job and requires business to reduce the depreciation base by the full investment tax credit, over $4 billion will be recaptured in the three year 1984-86 period. Reducing the credit from 10% to its previous 7% level will raise over $14 billion in the 1984-86 period.

9. Limit the small business corporate tax rate to smaller corporations. Under present law the first $100,000 of corporate net profit is taxed at a maximum of 26.75%. But under current law large corporations also get this reduction. Limiting the rate to small corporations would raise over $4 billion in the 1984-86 period and also help the competitive position of smaller businesses.

10. Eliminate the percentage depletion and immediate expending of drilling costs for the oil and gas industry. Along with termination of the 1981 changes in the windfall profit tax, revenues would increase in 1984 by $3.7 billion and generate revenue increases of over $15 billion during the 1984-86 period.

These are some of the changes which can be made to the federal income tax structure which will increase its fairness, help solve the nation's serious economic problems and help reduce the federal deficit. We thank you for this opportunity to present our views on this most important subject.

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Senator GORTON. In your written testimony is a criticism of tax indexing and a recommendation that it be repealed.

Mr. KENNEY. A criticism of what?

Senator GORTON. Do you not recommend that tax indexing be repealed?

Mr. KENNEY. Yes.

Senator GORTON. Query whether that is consistent with the interests of your own members. If you are at the maximum tax rate, indexing is not especially important, though it has some importance. Are not most of the people who are members of the labor unions and who are at work substantially benefited by tax indexing? And what is your response to the argument that Congress ought to pass tax increases in a straightforward fashion rather than permitting—and being encouraged, for that matter, to permit—inflation by doing the job for them?

INDEXATION OFFERS LESS

Mr. KENNEY. There is an assumption in tax indexation that the Consumer Price Index makes sense. It makes good sense for mathematicians. I am not sure it makes good sense for a lot of people who live in the world. It is based upon a lot of costs that are episodic costs. One buys a home once every 7 or 8 years. Nevertheless, the Consumer Price Index measures the cost of a home on a monthly basis. Major appliances that are bought every 3 or 4 years are measured in the Consumer Price Index every month. There are a lot of inequities in the Consumer Price Index because it exists. I understand we use a lot of it in collective bargaining contracts. But that tends to come with inflation and becomes a substitute for a bargaining tool at a time when all costs are rising. And that becomes a simple way to compensate for some of the lost purchasing power because the Consumer Price Index seldom recovers anything near even 50 percent of the increase in prices. And the current price increases, I would guess, probably only effective to the extent of 50 percent because that is consumption items like food, fuel. But I suspect half of the items in the Consumer Price Index—and I have not looked at it closely for a number of years—are major costs that we only incur no more often than every 3 or 4 years: automobiles, major appliances, homes. So, the Consumer Price Index is at best not a very good measure.

Second, as workers we have got to look at the tax system from two points of view. One as those of us who pay taxes; second, as we receive government services. And indexation is going to reduce government revenues and significantly over a short period of time.

We are recipients of government services, and I think that there has been a significant decline in the level of government services over the last several years since the Reagan administration. And it is showing itself less in services of a consumption nature than reinvesting in our infrastructure, the government providing jobs for those who need it, the government providing training for those who need it. There has been a tremendous decrease in the amount of training funds available.

There has been, it seems to me—and I have no statistical analysis for this, but I swear to God the roads are a lot worse than they were in 1980, quite apart from whoever is in government. That is largely a local responsibility, I know that. But it seems to me that even the city streets are not in the shape they were in a few years ago. There are a lot more potholes.

So, from the point of view of looking at the total tax structure both as payers and recipients, it seems to me indexation offers less to us than a stable tax structure would offer in terms of services provided for our people.

That is a long answer to a fairly short question, and I am sorry.

Senator GORTON. I would have been surprised, Larry, with our knowledge if you had said anything nice about the 1981 tax law changes.

Mr. KENNEY. I said something nice. I said it serves as a good bad example.

Senator GORTON. Yes, and there are even some elements of it with which I do not entirely agree. But I would like you to comment on the proposition that it seems to me that a significant portion of your critical statement is a year or two out of date. You criticized it as having failed to produce employment and instead reducing employment. But does this not fly in the face of the fact that we have just reported the lowest unemployment since April of 1980 and that we are below the unemployment level with which this administration started nationally and that the economic recovery and job creation in the last year or year and a half has been significantly greater than it has been in most recoveries out of a recession? How do you square those? It was a good argument a year or two ago, but is it not losing some of its force now?

RECOVERY NOT OCCURRING IN SKILLED JOBS

Mr. KENNEY. Senator, like you I read the statistics, I read the newspaper, and I hear the glowing reports. I am sure that the Bureau of Labor Statistics is not composed of political hacks. Nevertheless, I am secretary-treasurer of a labor organization. It is a statewide organization. It is based upon the membership of unions and the number of members in those unions. My income this year, even with the 10-percent increase in the basic amount paid, was 11 percent below what it was in 1980. I do not know who are getting these new jobs——

Senator GORTON. When you say, "My income," you mean your unions?

Mr. KENNEY. The State labor council.

Senator GORTON. Yes, OK.

Mr. KENNEY. My organization, I should say. Which would indicate probably a 20-percent decline in affiliation with the Washington State Labor Council.

Not all unions belong to the State labor council. Most of them, I would hope, would. But most of them pay a pretty honest measure on their membership. And they are paying less because they had fewer members. If the recovery is coming, it sure as hell is not coming in the construction industry. It is not coming in manufacturing. It is not coming in those areas which are traditionally good-paying jobs.

If there is a recovery, I do not know where the recovery is occurring. But it surely is not occurring among the skilled jobs it seems to me that we need. I do not see the recovery. I do not see union members going back to work. And that is the employment I deal with. I do not know why we are not participating in this recovery. Or does the recovery not really exist. I do not know. What I experience on a day-to-day basis does not square with what I read in the newspapers. And I do not know how to handle it.

Senator GORTON. Let me ask you one more much more specific question in that respect. Your statement indicates opposition to the foreign sales corporation export promotion mechanism. But as you are quite well aware, there are quite a number in this State who feel that substantial employment—and I think substantial union employment—can be attributed to that program. Do you disagree that that is the case? And do your views represent the views of your members, particularly Boeing members and so on who seem at least to be quite dependent on it?

Mr. KENNEY. Some of this is AFL–CIO testimony. When you called me a week ago and asked me to give you a statement, a lot of it I am going to borrow from Arnold Kantor and my friends back East.

Senator GORTON. Maybe you disagree with them on a couple of those things.

Mr. KENNEY. No, I doubt that I disagree with what my guys back East tell me.

Senator DURENBERGER. There are some things in there you probably should disagree with.

Mr. KENNEY. I am aware at least of the DISC's because the DISC was created when I was in public accounting. I am a public accountant.

Senator GORTON. It is No. 7 on page 5.

TAX INCENTIVES BECOME SELF-DEFEATING

Mr. KENNEY. Yes. I am not aware quite what the foreign sales corporations are, but I can speak with some knowledge of DISC's. I think the point has been made by Gladys and apparently by people before her—Professor Hjorth—that tax incentives do not really do an awful lot. I think that overall I am probably inclined to think that tax incentives do tend to become self-defeating after awhile.

One of the real problems is that there are so many tax incentives now that corporations can avoid paying corporate income tax. And how the hell are you going to give them any incentive in the future if they do not pay the taxes now?

I do not know how the foreign sales corporation is going to work. I do know that the DISC's did not seem to create employment or exports because the Commerce Department used to have seminars in which they would encourage people to use the DISC's because the tax break was there and people did not know about it and they were not using it. What they discovered was that there was a market overseas and that they could sell a product with a profit overseas, and they went about doing it. And then the Treasury Department or the Commerce Department found out, "Well, hell, you know, you guys are entitled to a tax break."

Businesses locate and businesses do things, it seems to me, where there is a market, where there is raw materials, and where there are people to do the work for them. A tax incentive tends more often than not to create unintended recipients and a loophole and a tax break for somebody. I am not convinced that all of the tax breaks for buildings are warranted, and I am not sure they have done a good job.

So, as I say, the State labor council became involved in a downtown condominium-office building development unfortunately. We are now out of it. It has been turned over to a private group of investors. And I could not figure out why they would take this building that had a debt of perhaps $27 million—as near as I could figure, it probably had a market value of $23 million—and why they would do it. But then I started figuring out the time value of money, writing off taxes today that are going to have to be repaid at a 40-percent rate 10 years from now, if ever. And suddenly it makes good sense. They can do it because the Federal Government is going to subsidize that building. And when it goes through enough reorganizations, it will become profitable for somebody. But it is going to cost the Federal Government probably as much as anybody is going to make.

Senator **Durenberger**. I just want you to tell me a little more, if you can, about your views on alternatives to the income tax. And I suppose some of these are relatively new in the discussion process, and I do not know whether these are Washington State conclusions or the national AFL-CIO conclusions. But it is a fairly significant position to take in opposition to the consumption-based taxes, not that I am for them. I do not have a position yet on one or the other. But, as I said in the beginning of this hearing, I have now spent 6 years with trying to tax income, and everything you say about it in here of course is true. You do not have to be in the chamber of commerce or the NAM or the AFL-CIO to come up with a very similar statement about the condition of the Federal income tax.

But it is very, very difficult in the short term. I mean, these recommendations from the AFL-CIO have been around ever since I got there. And from all I can see, most of them are going to still be in recommendation form for years from now, but the country is going to be $1.2 trillion farther in debt. So, we are sort of all searching around for some better ways to do it. And I do not know what position you take when we get to defense spending. But when I sit there on the floor of the Senate, it looks to me like the AFL-CIO does not mind a little defense spending. I mean, they want it within reasonable limits. But they want it when it comes to Social Security reform. By God, there is not much reform that ought to be there except maybe knock a millionaire off the top or something or medicare or pensions. As I whip through that whole list, it is tough for me because everybody I know in the AFL-CIO in my State came up the hard way. They are hard workers. They are all in that tough tax bracket where you do not have any shelters, and the spouse is working and they are trying to put the kids through college and all that sort of thing. And you really ought to be very frustrated by these things.

I just wonder, what is behind the position that says we should not have a national alternative to an income tax?

CONSUMPTION-BASED TAXES FALL HEAVIEST ON SPENDERS

Mr. **Kenney**. Consumption-based taxes fall most heavily on those who have to spend their money. That is the low-income and senior citizens. That is the most compelling argument against consumption-based taxes.

There are two things you can do with your money. You can spend it or you can save it. Consumption-based taxes—if you spend it, you pay taxes on it; if you save it, you do not.

I worked too many years as a printer with kids, and I did not save any money. I can save a little bit now. And so the tax burden would be less heavy on me now than it would have been in all the years when I was the sole support of my wife and three children.

Second, as Senator Gorton knows, we in the State of Washington rely very, very heavily on consumption taxes. We have a very unstable base and a very, very regressive base.

Senator **Durenberger**. Do you favor income taxes?

Mr. **Kenney**. Yes, sir.

Senator **Durenberger**. Does AFL-CIO strongly favor an income tax?

Mr. **Kenney**. Oh, yes, sir. We say the problem is not finding a new tax system, but restoring equity and fairness to the tax system we already have.

Senator **Durenberger**. How about horse racing and lotto and some of those things; is the AFL-CIO in favor of those forms of taxation?

Mr. **Kenney**. Horse racing and lotto?

Senator **Durenberger**. Gambling at the track, gambling at either the Federal or the State level, or lotto or any of those sorts of things?

Mr. **Kenney**. You mean, a Federal lottery for horse racing?

Senator **Durenberger**. No. How about at the State level?

Mr. **Kenney**. I do not think the AFL-CIO State Labor Council took a position on the gambling bill. So, I cannot speak for them. I can only give you a personal opinion, and I do not have personal opinions when I am speaking for the organization. [Laughter.]

And, as far as I know, we have no position on off-track betting.

Senator **Durenberger**. Why do you not have a position against it since it falls most heavily on—or does it necessarily fall most heavily on—is it only the rich that gamble?

Mr. **Kenney**. I can remember when I was taking economics out at the university, and the econ professor said that a tax on gambling is probably the best tax of all. It is the only one people are willing to pay. They rush across the street to pay it.

Senator **Durenberger**. So, you make that distinction between the willingness and the ability.

Mr. **Kenney**. I do not make any distinction. I do not know why we do not have a position on State gambling laws. So, I cannot really speak for the organization.

CONSUMPTION-BASED TAX IS INEQUITABLE

Senator DURENBERGER. The opposition to the consumption tax is then based on the lack of progessivity, lack of ability to pay, just like your opposition to the flat-rate tax. It sounds to me as though it is premised on the fact that it is inequitable as among various income levels; is that correct?

Mr. KENNEY. Yes. Consumption-based taxes fall on those who have to spend; and those who have to spend are those who do not have very much money.

Senator GORTON. But you have the same criticism of a single or a flat-rate income tax.

Mr. KENNEY. The flat-rate income taxes I am not really all that familiar with. I know it sounds very, very good. But I get very, very turned off by——

Senator DURENBERGER. It is called a hoax in here.

Mr. KENNEY. Yes, it probably is. But I think what it says is they set an example of all the progressivity because the argument that was made when we talked about a flat-rate tax in the State of Washington was that something like 75 percent of the taxes came out of that first bracket. Well, everybody is in that first bracket. That was playing with numbers there. A lot of people never get passed that first bracket. That is why most of the revenue comes from that first bracket.

Senator DURENBERGER. The last question: there is nothing in here on fringe-benefit taxation. Do you know if the labor council has a position on the subject?

Mr. KENNEY. If you are talking about taxing medical benefits, we do not believe they should be.

Senator DURENBERGER. Any fringe benefits.

Senator GORTON. Free airline travel for airline employees.

Mr. KENNEY. Do we have a position on that? I am sorry, my expertise tends to be in State taxes rather than Federal taxes because that is where I deal for the most part.

Senator DURENBERGER. OK, thank you very much.

Senator GORTON. Thanks, Larry. It is nice to see you.

Mr. KENNEY. Thank you, Senator.

Senator GORTON. Our final panel is Mr. Hoppel and Mr. Koetje. We would appreciate their coming forward.

Mr. Hoppel, I guess we will start with you. We will hear from both of you before we ask questions.

I will say again both of your statements, since you have submitted them to us, will be included in the record in full.[1] You can go through them or summarize them as you will, to give us a little bit more time for questions.

STATEMENT OF ARMAND B. HOPPEL, PRESIDENT AND CHIEF EXECUTIVE OFFICER, BLUE CROSS OF WASHINGTON AND ALASKA

Mr. HOPPEL. Thank you very much, Senators, for inviting me to testify here today. I am overwhelmed at the size of the audience.

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[1] See pp. 82 and 92.

I am going to skip over a part of the prepared documentation to save time. I might explain I am here as the chief executive officer of Blue Cross of Washington and Alaska and as well as board chairman of our subsidiary, Health Plus, which is a recently organized HMO—the only federally qualified HMO, incidentally, in the State of Washington. So, we are addressing principally the issue of the tax cap on health care, the fringe benefits, and that kind of thing.

S. 640 WOULD CAP TAX EXEMPTION

I had some comments about cost containment because I think that is an integral part of this whole concept of financing health care and where health care costs are going and so forth. And I made some comments in my written documentation about what we are doing in that regard, but I will skip over that and simply proceed by saying that our demonstrated concerns about the cost of health care and what we are doing about them, combined with our sense of responsibility, provides perspective as to why we are strongly opposed to the provisions of the tax cap proposal as contained in S. 640.

As we all know—all of us here, that is not very many, my staff. I have two of my staff here. This act, if adopted, would cap the tax exemption for employer-paid health care programs. And we do understand there is a secondary objective besides that of producing additional tax revenue, and that is to help contain health care costs. And we feel that while that may be good in theory, a tax cap will certainly not have that effect in reality. We feel that it will lead individuals to opt for lower cost health care service alternatives and thus slow the rise in cost while providing additional revenues for the Government, is not a valid assumption. I do not think that goal will be met. And I am going to address that in a little bit more detail. I think any amount of disturbance in the methods of financing health care, complicated by the problems we are having in medical inflation, could have some very serious results and already have had some serious results in terms of what has happened over the past 2 or 3 years. We have got a number of people who are working, for example, on committees for those who are disadvantaged relative to being unable to buy insurance, medical insurance, yet not being in the sufficiently lower income category to receive help from medicare.

So, we already have a segment of the population who really cannot get the kind of either insurance for health care or health care that perhaps they should.

We believe that a tax cap would result in increased hospital utilization as employees and employers respond to arbitrary limitations on health care subscription and premium costs. We know from our years of experience that when benefits are reduced, those eliminated from policies are benefits which are the most helpful in lowering overall health care costs.

PEOPLE LEAVING FIRST-DOLLAR COVERAGE ARENA

There has been some discussion in a number of papers and many things done over the past few years relative to the influence that first-dollar coverage has on utilization on utilization trends. I might say that we have been getting out of the first-dollar coverage arena for a number of years. And I just checked with our actuary this afternoon before I came down, and we find that most of our groups now—smaller groups—particularly the ones that are really having problems financing health care premiums, are switching over to the up-front deductibles, coinsurance, and that kind of thing.

We have always subscribed to the concept of as much service out of the hospitals as possible. And the only reason I mention this is because the picture has been quite different in the East. And we have operated in a different manner out on the west coast for quite some time.

So, we are concerned that what will happen as a result of this kind of imposition of a cap, which then implies that several things might happen—one of these things would be the selection of a benefit package that would tend more to cover the heavier ends of the medical care bill, which would probably lean a little bit more towards hospital coverage, and then perhaps force us back into the arena of people being admitted to hospitals to receive benefits. It is kind of a dog-chasing-its-tail kind of thing.

There would be a number of other kinds of preventative services which are now covered under some of our programs that could be dropped—such things as home health services, mental health services, preventative services, dental services, and some out patient prescription drugs. It is really amazing to see how people start hacking away at their benefit levels as they perceive a rise in premium that they can no longer afford. They in some cases do away with the things that might in the long run do more for them than anything else in terms of preventative kinds of medicine. And this I am deeply concerned about because we feel it would dampen, could dampen, the growth of the SMO concept.

I just took a look at the rates of our HMO before I came down. We have three plans. I would like to just give you an idea. I think we are already talking about caps of $75 and $175. I think we are already there. We have a plan A, B, and C, and they are all HMO-type plans, what you might call first-dollar coverage up front, although it does not look that way. And I see the family rate for plan A is $188.26. The family rate for plan B is $180.56. And the family rate for plan C, which is the lesser of the three plans, is $169.59. The single rates run about $65 to $68.

Senator DURENBERGER. Is that a combination of Washington and Alaska, is what you are saying?

SUBSTANTIAL DIFFERENCE IN HEALTH CARE COSTS IN VARIOUS AREAS

Mr. HOPPEL. No, we do not have this kind of operation as yet up in Alaska. Obviously if Alaska were included in the theories that I am developing here, we would have to take a look and say: Is $75 and $175 even realistic at all going in? So, I do not know how you would handle that kind of disparity. I have noted further on in my testimony here—and I think I am probably going to divert quite a bit and jump around—that there is a substantial difference—and your comment on Alaska points that out—between health care costs in various areas. And I am looking for a particular quote here. This is from the Health Insurance Association of America study that medical coverage that costs $2,172 a year for a family in Greensboro, SC, would cost $5,063 in Los Angeles.

Senator **Durenberger**. Does it show any reason why it has to cost that much?

Mr. **Hoppel**. The study may indicate why they feel it costs that much. I think I can tell you why. There are a great deal of practitioners in southern California. It seems to be a popular spot not only for people who retire and that kind of thing, but also for people who practice medicine and so forth and so on. But I am sure it goes far beyond that. But that gives you an idea of the differential in costs between, let us say, South Carolina and Los Angeles. I do not know what calibre of care we are talking about either. These are just broad figures obviously that have to be researched.

If we take a look at Alaska, I think we would probably find that Alaska would be up somewhere close to California, but maybe not exceeding California too much. And this is hard to determine; these are premium costs. It is hard to determine what kind of coverage. I have to assume that they used common kinds of coverage. But I thought that point was interesting when you asked about Alaska; it brought me to think about that.

LARGER CORPORATIONS SWITCHING TO SELF-INSURANCE PROGRAMS

I think one of the elements that we see increasing in the mechanisms that are used to provide health care are those larger corporations—and it is getting so the larger corporations are becoming smaller in size—that have switched to self-insurance. And in most cases they do utilize intermediaries or administrators. And we have in this kind of business also to process claims for them and take care of those kinds of things.

As I understand it, under this proposal, self-insurance programs seem to fall through the crack. In other words, the company is not paying a premium to someone per se by which a value of $75 for a single or $175 for a family could be measured. As I understand anyway, the larger firms who have self-insurance might fall through the cracks on this thing. And that I am not sure about, but I think it is something to consider because if it turns out to develop another tax dodge, if you want to call it that—I do not choose to call it that, but one could—that is the way to do it, is to go self-insurance. That poses some problems, but larger corporations that do not go that route now might feel tempted to do so.

Senator **Durenberger**. I think we would handle that one the same way you would handle it if you were bidding on a management contract form. You would find a way to estimate those costs. And I think HCFA would probably do the same thing under this proposal, would put a dollar value on it.

Mr. **Hoppel**. So, anyway, I think there is an element there of concern that would have to be looked at. I guess, to make a long story short—and I do have many pages of testimony here—to make a long story short, I really do not think we are going to see any drastic increases in Federal tax revenue by virtue of this kind of tax cut. And I particularly do not feel that it is going to have the salutary effect on containing hospital costs or medical costs that some people claim. I again feel that what we will see is an increase in the total costs of health care in a particularly disadvantaged group. I mentioned the people that are already unable to buy insurance. And then I talked about the large employers who might go self-insured.

EMPLOYERS WHO CANNOT GO SELF-INSURED HAVE SERIOUS PROBLEMS

And then we have the other problem of the smaller employer—let us say with people from 5 to 100. One of the principles of, quote, "insurance," unquote—we are a health care contractor, but we do have to work on insurance principles—is the spreading of risk. And, so, what happens to our capabilities to, in some cases, underwrite losses in certain lines of business for social reasons, our group-conversion policies and some of those kinds of things—when those moneys stop coming in and we stop being able to spread the risk amongst a broader segment—and the administrative expense too, although we try to relate that to the amount of business that we do.

So, I think there are serious problems for the group of employers who cannot go self-insured, if there is indeed a way to escape paying some tax on excesses over those caps. And then that gets those employers into really cutting their benefit programs down.

I asked our actuary: What is the "worst," quote-unquote, in terms of coverage, if you want to call it that, that we are selling right now? And it is a 50-percent coinsurance program up to $750 of expenditure, and then from then on it gets into a catastrophic kind of thing and so forth. And it tends to discourage people from preventive and early care. And I think there are many other ways that we can attack the costs of health care without this concept of taxing premiums over *x* number of dollars. That is basically our position, to make a long story short because I know that we are getting late.

Senator GORTON. Thank you.

[The prepared statement of Mr. Hoppel follows:]

PREPARED STATEMENT OF ARMAND B. HOPPEL, PRESIDENT AND CHIEF EXECUTIVE OFFICER, BLUE CROSS OF WASHINGTON AND ALASKA

Senator Gorton, members of the Senate Budget Committee, ladies and gentlemen:

I am Armand B Hoppel, President and Chief Executive Officer of Blue Cross of Washington and Alaska. I appreciate the opportunity to appear before the Senate Budget Committee and to present our views on the proposal to place a tax cap on health care benefits.

As the major health care service contractor in the states of Washington and Alaska, we strongly share the concerns of employers, insurers, government and consumers related to the delivery and costs of health care. Blue Cross of Washington and Alaska has assumed and continues to assume a leadership role in programs directed toward restraining and containing costs in the health care system. Our management people are deeply involved in planning agencies, legislative activities and other areas where our involvement may result in lowered costs. These areas include all aspects of utilization review, such as mandatory second opinion and outpatient surgery, implementation of stringent medical necessity guidelines, the restructuring of benefits relating to consumer awareness and participation in costs, and alternative methods of provider reimbursement. The Plan has been actively involved in the development and adoption of cost containment legislation with emphasis on the statute passed in the State of Washington reauthorizing the State Hospital Commission. This law provides for increased price sensitivity and competition among providers.

The Plan's Cost Containment Committee, made up of senior staff officers, has been responsible for developing and implementing the cost containment activities which I have already listed. In the area of alternative delivery systems HealthPlus, the Plan's subsidiary HMO is witnessing rapid growth in membership and represents a substantial competitive factor in the state.

Blue Cross has also established a comprehensive worksite wellness program, a capitated dental program, hold harmless dental and vision programs with participating providers, and a hospital audit program which checks for medical necessity and appropriate practice as well as billing accuracy. We have implemented a state-of-the-art computerized data reporting system which provides account-specific information on utilization to employers. These cost containment activities are reflected in the theme of our current advertising program which is "drawing the line" on health care costs. Our commitment to cost containment activities reflects our philosophy that the only share holders the Plan has are our subscribers. We feel a deep responsibility to them in holding down subscription costs.

Perhaps these demonstrated concerns about the cost of health care and what we are doing about them, combined with our sense of responsibility provides perspective on why we are strongly opposed to the provisions of the tax cap proposal as contained in S 640.

As we all know, this act, if adopted, would cap the tax exemption for employer-paid health coverage programs. We understand the two basic goals this legislation hopes to achieve are the containment of health care costs and increased revenue for the federal budget. In theory, a tax cap is expected to create a disincentive for charging a premium higher than the cap, leading individuals to opt for lower cost health care service alternatives, and thus slowing the rise in costs while providing additional revenues for the government. This may sound well in theory, but it will not achieve these goals. It will instead result in hardship to a wide segment of the population.

Blue Cross of Washington and Alaska believes that a tax cap would unquestionably result in increased hospital utilization as employees and employers respond to arbitrary limitations on health care subscription and premium costs. We know from many years of experience that when benefit levels are reduced, those eliminated from policies are benefits which are the most helpful in lowering overall health care costs. As we have increased coverage for physician outpatient services over the years, we have seen a substantial reduction in use of expensive inpatient services. We are, therefore, concerned that as coverage for outpatient services may be eliminated, the use of higher cost inpatient services will increase. Other cost effective benefits likely to be dropped include home health services, mental health services, preventive services, well baby care, dental services and outpatient prescription drugs, as well as life style and wellness programs.

The tax cap would also dampen the growth of HMOs since the comprehensive benefits they offer will be impacted by taxation of costs above a certain limit. As all of us in the industry have come to realize more and more clearly, if cost restraint is to be achieved, health care resources must be directed toward the prevention of illness rather than treatment of disease. The growth of these preventative programs in HMOs and in traditional coverages will be inhibited by the tax cap.

A recent study at the National Center for Health Services Research conducted by Gail Wilensky, lends support to the concerns I have expressed. The Center reported that employees with less extensive employer contributions to their health insurance premiums are less likely to have coverage for preventive services such as vision or hearing care, prescription drugs, routine physicals or outpatient psychiatric care. Employees with the highest employer contributions were more likely to have complete coverage for physician care. The one area of insurance which does not seem to be significantly affected by the level of employer contributions is coverage for catastrophic expenses.

The most overriding and disasterous result of the tax cap proposal is found in the aspect of adverse selection. This proposal would have the effect of forcing employers to develop more than one plan of coverage for their employees. The younger, more healthy employees are most apt to choose a plan without a broad range of coverages. On the other hand, older workers who utilize more services because of predictable greater health care needs, or those employees with health problems in their family, are more apt to choose a broader, more comprehensive plan. High utilization will make that comprehensive plan more costly and, even, possibly uninsurable. The important insurance principle of spreading the cost of health care over the wide range of the work force will be lost, with potential ramifications in hiring (or more accurately non-hiring) of older and disabled workers.

Additionally, we have concerns that the choices of coverage which this proposal will generate will increase costs for government. Persons choosing less comprehensive coverage often make that choice without consideration of the possibility of serious accident or illness. Persons without sufficient coverage, who suffer a catastrophic episode, are more apt to become Medicaid recipients and that would increase health care costs for government. We are seeing a trend in this direction and this proposal would accelerate that movement.

Let me now focus on the other goal that the tax cap hopes to achieve---that of raising additional revenues. It is our perception that the tax cap will not significantly raise revenues. The most predictable response to a tax cap would be for employers to decrease their health insurance expenditures by narrowing the benefits provided to employees to get under the tax cap. This maneuver would avoid the tax altogether and generate no new revenues. In addition, employers and employees are apt to simply shift the health insurance benefits to other non-taxed alternatives in order to keep the compensation tax-exempt.

Let me point out an example from Barrons Financial Weekly of June 20, 1983, illustrating what you can expect. "On the very day S 640 was introduced the (United) Steelworkers signed new contracts with Armco, Bethlehem, Inland, Jones and Laughlin, National, Republic and U.S. Steel, which provide that if benefit caps are passed, the union and the companies will 'meet to consider revisions which would minimize worker tax liability'." I would venture a guess that at the end of a renegotiation between steel and labor, (assuming a tax cap was law) the federal treasury would not have realized any additional revenue from the employees of the steel industry. Things are difficult enough in that industry without adding costs which detract from international competitive ability. I would suggest that not only your constituents in the steel industry but employees of all industries are apt to voice their resistance to this tax cap proposal.

In additionn, employers would be motivated by this legislation to develop a method of non-premium arrangements which would in effect "skirt" the tax cap. Much of the group health insurance provided today is not based on what is commonly referred to as "premiums" attributable to individuals or families in an employer's group. Coverage today can be based on various kinds of self insurance which would be exempt from the proposal. I have reference to multi-employer trusts; "administrative services only" contracts and other methods different from traditional employer-employee health insurance programs. Large employers could escape the cap by simply moving to ERISA tax exempt funding methods, but this option is not open to small employers to whom Blue Cross of Washington and Alaska has a strong commitment. The tax cap may exacerbate the present trend toward self insurance and further complicate the role of small employers in the purchase of health care coverage.

Perhaps above and beyond all of this, the tax cap would represent a regressive tax on the covered worker which I suspect would concern the members of this committee. It is a fact that health care costs are not the same in all parts of the nation. They vary substantially and subscription and premium amounts resulting from these divergent costs vary accordingly.

For example, according to a Health Insurance Association of America study, medical coverage that costs $2,172 a year for a family in Greenville, South Carolina, would cost $5,063 in Los Angeles, California. Since S 640 would tax benefits over $2,100, the worker in Greenville would owe taxes on only $72 of the family's medical benefits while the west coast family, which has no greater coverage, would have $2,963 subject to taxation.

In addition, the way the proposal is structured, lower income employees would be subject to proportionally greater taxation for benefits. For example, a taxpayer in the $20,000 income range would have a greater tax to income percentage than would the taxpayer in the $100,000 income bracket. A study by Deborah Chollet of the Employee Benefit Research Institute shows that 57% of the individuals with employer-paid health care coverage have an adjusted family gross income of $25,000 annually.

In summary, we recognize that S 640 has been proposed as a way to reduce overutilization of health services---an objective we unquestionably support. Blue Cross believes, however, that the tax cap is a misdirected effort and we are very much concerned that it will cost the nation's health care purchasers more in higher hospital utilization than it earns for the government in increased revenues.

The tax cap would create an environment that forces employees to choose health coverage that is the least cost effective, moving away from preventive and other cost effective options. The tax cap would severely impact the insurance principle of risk sharing through increasing adverse selection. The tax cap is regressive and will not have a significant effect on reduction of the federal budget deficit.

In closing, I would like to suggest that the tax cap proposal perhaps fits in the same category as other cost containment activities that represent attempts at short term solutions to the health care cost problem. These attempts must be placed in a much broader long term perspective as we judge significance and effectiveness. Apparently the intent of the proposers of the tax cap is to stabilize costs and limit escalation to the overall inflation rate. The proposal is directed toward increasing consumer awareness as a result of a greater degree of participation in costs. While there may be other viable programs that would effectively achieve this purpose, any such efforts pale in significance when considered along with underlying and overwhelming factors of cost increase which are of staggering proportions. I have reference to the aging of the population, the accelerating explosion of medical technology, and the implied bioethical issues. It seems to me we are currently over-concentrating on short term and Band Aid approaches and are not adequately relating and dealing with these extremely complex issues. I realize this is not involved in your specific deliberations of today, but these considerations represent a very deep concern to me. We all need to move in these broader directions.

Again, I appreciate the opportunity to present my views and those of Blue Cross of Washington and Alaska. As a final note I urge your consideration of the reasons I have given in opposition to the tax cap proposal.

Senator GORTON. Mr. Koetje.

STATEMENT OF GORDON KOETJE, PRESIDENT, WASHINGTON ASSOCIATION OF HOME BUILDERS

Mr. KOETJE. I am not here on insurance, but I would like to thank the panel for inviting me here. My name is Gordon Koetje, and I am a home builder and developer of Oak Harbor, WA. I appear here today on behalf of the more than 2,600 members of the Home Builders Association of Washington State. I am the president. HBAW is pleased to present its views on Federal tax reform.

I would also like to submit a prepared statement, drafted by our national organization, for the record.

Senator GORTON. It will be included in the record as if read in full.[1]

Mr. KOETJE. The HBAW shares the commitment of the Senate Budget Committee and the Senate Finance Committee to explore ways to balance the deficit spending of the Federal Government.

BUILDING INDUSTRY SUPPORTS NONPARTISAN APPROACH TO PROBLEM

We support a nonpartisan approach to this problem and would encourage this to be done as soon as possible. We from the building industry are hearing some approaches and proposals which concern us as providers of housing. This is a commitment we made many years ago when the associations such as NAHB and HBAW were formed. We feel that the Federal deficit is way out of line. We feel every time there is a move to do something about the deficit, the

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[1] See p. 93.

Federal Government looks to housing to help. We feel this is not always fair.

There are proposals to take the homeowners' mortgage interest deductions away from the owners and prospective home buyers. We feel this would be devastating to the homeowners and buyers of the United States. With an average family income of $35,000, this married couple without home mortgage interest deductions would only qualify for a $53,000 home mortgage. The way the tax incentives are today, this couple can qualify for a $70,000 home.

So, I would like to caution you on any tax reform which is going to take the buying power away from the buying and voting public.

You also are looking at other down payments on the deficit. One that does bother us is the approach to take some of the incentives out of being a businessman. It does not give the man or woman that is willing to put her or his dollars on the table to make business go and create employment for others by taking some of the tax benefits away. We feel there are lots of other ways to accomplish this and other things that could be done in Congress' own backyard. One is: Please clean up your house, and we will clean ours. We need to put down the axes and pick up the chips and put those together with a bipartisan approach.

We home building industries will support that type of approach to our problem. We get sick and tired of hearing whose fault it is that the country is in the shape it is in today. We do not care if it is the other party or the other person that was there before you because right now we are looking to you for answers, and we do appreciate the fact that you are trying and willing to keep trying. So, from NAHB and HBAU we applaud you in your endeavor to get this country back on the right track.

And I would like to thank you for this opportunity to present my views and try to answer any questions that you may have.

Senator GORTON. Thank you.

[The prepared statement of Mr. Koetje follows:]

STATEMENT OF
HOME BUILDERS OF WASHINGTON STATE
BEFORE THE
SENATE BUDGET COMMITTEE
ON
FEDERAL TAX REFORM
JULY 9th 1984
SEATTLE, WASHINGTON

Mr. Chairman:

My name is Gordon Koetje. I am a Home Builder and Developer from Oak Harbor, Washington. I appear here today on behalf of the more than 2,600 member's of the Home Builder's Association of Washington State in which I am president. H.B.A.W. is pleased to present its views on Federal Tax Reform.

H.B.A.W. shares the commitment of the Senate Budget Committee and the Senate Finance Committee to explore ways of balancing the deficit spending of the Federal Government.

We support a non-partisan approach to this problem and would encourage this to be done as soon as possible. We from the building industry are hearing some approaches or proposals which concern us as providers of housing. This is a commitment we made many years ago when Associations such as N.A.H.B. and H.B.A.W. were formed.

We feel that the Federal Deficit is way out of line. We feel every time there is a move to do something about the deficit the Federal Government looks to housing to help. We feel this is not always fair. There are proposals to take the Homeowner's Mortgage Interest Deductions away from home owner's and prospective home buyer's. We feel this would be devastating to the home owner and buyer of the U.S. with an average family income of $35,000. This married couple without Home Mortgage Interest Deductions would only qualify for a $53,000 home mortgage. The way the tax insentives are today, this couple can qualify for a $70,000 home, so I would like to caution you on any tax reform which is going to take the buying power away from the buying and voting public.

You also are looking at other down payments on the deficit. One that does bother us is the approach to take some of the insentive out of being a businessman, it does not give the man or women that is willing to put her or his dollar on the table to make businesses go and create employment for others by taking some of there tax benefit away. We feel there are a lot of other ways to accomplish this and other things that could be done in Congress' own back yard, one is please clean up your house and we will clean ours. We need to put down the axes and pick up the chip and put those together with a by-partison approach.

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Thank you for the opportunity to present my views. I would be happy to answer any questions you may have.

STATEMENT OF
NATIONAL ASSOCIATION OF HOME BUILDERS
BEFORE THE
DEPARTMENT OF TREASURY
ON
PUBLIC HEARINGS ON PROPOSALS TO REFORM THE FEDERAL INCOME TAX

June 26, 1984

Washington, D.C.

Mr. Chairman:

My name is Dave Smith and I am a homebuilder and developer from McDowell, Virginia. I appear here today on behalf of the more than 125,000 members of the National Association of Home Builders (NAHB), of which I am Vice President Treasurer. NAHB is pleased to present its views on revision of the tax system.

NAHB shares the commitment the Department of Treasury and the Secretary of Treasury to explore ways of revising the tax code. NAHB is concerned that many of the proposals currently being considered reduce complexity at the expense of economic efficiency and fairness and could lead to shifts in national policy. Tax incentives are a major component of housing policy especially since direct housing subsidy programs have been virtually eliminated. It should be noted that NAHB has supported this policy direction as part of a general policy of reducing growth in government spending and encouraging private sector capital formation. It has been our belief that free market incentives are more effective than other alternatives.

Because of the effect of tax policy on housing and housing policy, tax revisions should not be viewed in isolation from other changes in housing policy and programs. Tax policy is of major importance to those who construct housing, to those who finance housing, and to those who eventually reside in it. We need a consistent tax policy which reaffirms our national commitment to affordable, quality housing -- both for homeownership and for rental housing. A consistent policy of support for decent housing and homeownership has been a national commitment for more than fifty years. A commitment to protect this principle should be a priority in any tax policy.

The homeowner's mortgage interest deduction is the most visible evidence of this commitment. Any modification of the homeowner's mortgage interest deduction would have a devastating effect on both the housing market and the economy. We believe very strongly that this provision of the tax code should remain.

The effect of tax policy upon housing extends well beyond the mortgage interest deduction and covers all elements of the housing industry. For example, the tax portion of the 1984 deficit reduction package recently agreed to by the House and Senate Conferees will amount to approximately an $8 billion tax increase for housing and the real estate industry. The average taxpayer and businessman has little knowledge of obscure tax code provisions involving partnerships allocations, like-kind exchanges, original issue discount accounting, and the capitalization of construction period interest and taxes. Yet each of these changes will increase taxes and the cost of capital for housing and ultimately the consumer, through higher rents or purchase prices.

NAHB is reviewing various tax proposals, but as we look at them, we need to keep in mind certain basic principles.

- Homeownership should be encouraged. Tax changes should not increase the cost of housing, particularly for those who are just entering the housing markets. Tax changes should maintain existing property values and should not result in diminishing the value of homeownership -- which is often a family's major investment. Homeownership is also important to to the community. It provides for social and political stability.

- A suitable framework for the evolution of the system of housing finance should be maintained. Dramatic changes are occurring in the way capital is accumulated to finance homes and rental housing. The marketplace has been able to utilize the existing tax framework to adjust to new trends which have developed. While far from perfect, existing tax rules should not be revised in such a manner which would jeopardize the evolutionary growth of the mortgage finance system and the important role which current players including FNMA, FHLMC, GNMA, and the private financial institutions play.

- Incentives for capital investment, particularly for the construction and ownership of rental housing should be maintained. Special consideration should be given to low income housing needs. We face a shortage of rental housing. New construction based upon existing tax provisions will not overcome the rental housing shortfall. Incentives directed toward capital formation for rental housing, particularly ACRS depreciation allowances and the use of partnerships as a means of capital accumulation for investment in rental housing, should be maintained and strengthened.

- The tax system should foster savings and capital formation. Economic productivity and growth requires private capital formation. Incentives to save and invest should remain as an integral part of the tax system and new savings incentives should be considered.

- Frequent changes in the tax law should be discouraged. Tax changes create investment uncertainty. Future changes should attempt to minimize potential market dislocations which the changes could create. Certainty which permits long-term planning is essential.

- Reform should facilitate tax compliance with an eye towards deficit reduction. Reform for the sake of reform is not enough. While the current law is far from perfect, for many taxpayers who use the standard deduction, it is relatively simple. It does promote desirable economic and social goals. It is relatively fair in terms of being progressive. Any change to a true flat rate tax will place a higher tax burden on low and middle income taxpayers unless appropriate exceptions are made.

FEDERAL DEFICIT

Although the Congress is moving toward enactment of a "down-payment" on the federal deficit in 1984, the need for additional reductions remain. NAHB shares the view of the political leaders and economic experts of this country: Budget deficits, of the magnitude we are experiencing, and are likely tc experience through the remainder of the decade, require a bipartisan plan. Last year NAHB developed a grassroots campaign focusing on the serious effect deficits have on continued economic growth and recovery. Deficits are indeed America's "ticking time bomb."

Developing a consensus on long-term budget issues will not be easy, but it remains absolutely essential for the major political parties of this nation to adopt a program to reduce the federal deficit.

Deficit reduction should not, however, be a signal to increase taxes at the expense of housing. The housing and real estate industry in the recent tax bill has paid its "fair share" and arguably more than its fair share in deficit reduction. The 1984 "down-payment" payment" raised approximately $8 billion in revenues on the real estate industry through 1987. This is about 15 percent of the total revenues raised. Future deficit reduction should be broad-based 'and should not place such a heavy burden on housing.

TAX POLICY AND HOUSING POLICY

In light of the previously discussed principles, we want to reiterate the importance of tax policy as it relates to homeownership, mortgage finance and rental housing.

Homeownership

Incentives for homeownership should be continued and homeownership should be encouraged. The most obvious incentive for homeownership is the mortgage interest deduction. Any system which eliminates the mortgage interest and property tax deduction would substantially raise the cost of housing for many households. The mortgage interest deduction makes ownership of a home affordable for many Americans. Take for example, a married couple with two children filing a joint return. Using the tax rates effective July 1, 1983, and assuming a family income of $35,000 per year, the mortgage interest deduction helps this family qualify for a $70,000 house. Without the mortgage interest deduction, the same family could qualify for only a $53,000 home. With the average price of a new home in the $70,000 range, the mortgage interest deduction becomes an important element in permitting ownership of a home.

While most proposals being considered retain the mortgage interest deduction, the effect of a dramatic reduction in tax rates upon the deduction should also be considered. From a tax point of view the value of the deduction decreases as marginal tax rates decrease. Therefore, this assistance for homeownership diminishes as marginal tax rates decline. Presumably, the reduced value of the deduction will be compensated for by provding lower tax rates, thereby giving most taxpayers additional capital to use for a home purchase. This, however, may not be the case and special provisions for homeownership may be necessary.

Not only could housing affordability suffer through elimination of the mortgage interest deduction and the deduction of property taxes, but property values could also diminish. This could also could occur with a dramatic reduction in marginal tax rates. Such action would adversely impact the savings of many Americans who view homeownership as their major investment. Care must be taken to avoid such a result.

Housing Finance

The present housing finance system is undergoing tremendous change. Tax revisions should point toward improving the access of housing finance to the capital markets. Current housing finance delivery systems should not be jeopardized in exchange for new or untried approaches.

The growing interest of financial markets in mortgages as investment is an important development for housing. The tax laws should provide a workable framework to permit new approaches while retaining established methods of housing finance.

The following points regarding mortgage finance should be considered in reviewing the tax law.

- Mortgage-backed securities are a principal tool for raising mortgage money in capital markets. The tax law should encourage the growth and development of mortgage backed securities by federally related and private entities.
- Builder financed home purchases utilizing the installment

sales provisions of the tax code are an important means for builders to provide the capital necessary for a home purchase, similar to current techniques for financing automobiles and appliances. This important financing tool should be permitted to continue.

- Tax exempt bonds issued by state and local governments continue to be an effective means of promoting the development of moderate income rental housing and providing homeownership opportunities for first-time homebuyers. This year, Congress overwhelmingly affirmed continuation of tax exempt bond-financed housing programs.
- To meet the mortgage capital needs of the eighties and beyond, it is essential to lower tax barriers to foreign investments in the United States.

Rental Housing

Multifamily housing is an essential aspect of any housing policy. NAHB anticipates a rental housing shortfall of more than 100,000 units per year over the next decade. Incentives for continued investment in multifamily housing are necessary. Yet, the history of recent tax legislation affecting residential structures has been a progressive diminution of the tax benefits associated with this type of investment. The requirement that construction period interest and taxes (IRC Section 189) be capitalized was introduced in 1976. No industry other than real estate construction is required to capitalize interest. Residential real estate also does not have the advantage of the investment tax credit, except for the rehabilitation of historic structures. In addition, the alternative minimum tax often affects capital gains associated with real estate investments more than it affects investments in other types of assets, particularly corporate equities or bonds.

From an investment point of view, rental housing has often not been attractive. Intensive management to maintain an adequate income stream is necessary. Costs of maintaining of rental property have increased considerably in recent years. In addition, income generated from rental property is lower than for other types of property.

Residential rentals do not generally carry CPI inflation increases, and the income of residents can only support a certain level of rent. Therefore, market rents generally do not create an income stream which is competitive with other types of investments. In addition, rent control in many jurisdictions has kept rents at below market levels.

As a result, tax revisions should establish special incentives for rental housing to permit it to be competitive with other types of investments. Tax changes should not have the effect of driving capital away from residential housing at a time when more, not less, capital is needed. Otherwise direct government subsidies will be necessary.

CONCLUSION

In conclusion, the American economy as well as the housing industry will face severe challenges over the next several years. Tax revisions must maintain a commitment to affordable, quality housing. Housing - both owner-occupied and multifamily

- are a principal source of economic growth. This commitment is more than economics; it extends to providing every American with a stake in their own community and our nation.

Deficit reduction, tax simplification, and affordable, quality housing must be given equal priority in any tax revision proposal.

Changes should consider the implications for homeownership, housing finance, multifamily housing, savings and capital formation, and should foster investment certainty and long-term planning. NAHB is studying the implications of various tax proposals but has not reached a definite position on the alternatives. We look forward to working with the Department of Treasury on this important issue.

Thank you for the opportunity to present our views. I would be happy to answer any questions you may have.

Senator GORTON. Mr. Hoppel, I have just one question for you. Senator Durenberger, as you know, is one of the Senate's immense experts in this field, and I am not. But I remember when the President first recommended this cap. He labored to state that this was not a tax increase. It was not recommended because it would increase Federal revenues, but as a cost-control mechanism with respect to health care.

You have been here long enough today to have heard testimony to the effect that, at least from the point of view of corporations, that the corporate income tax has almost disappeared, that it is much, much smaller share of Federal revenues than it was even a few years ago.

Does that fact weigh in your opposition to this proposal?

Have you found any change over the last several years in the attitude of corporations, major or minor, toward health care costs? Have they felt in the past that since they were deductible, that it was a matter of essential indifference to them as to what those costs were? Are they more cost conscious today as corporate taxes go down than they were before? Did they really push you to the wall on costs when they negotiate with you?

HEALTH CARE COSTS CAUSE TREMENDOUS CONCERN

Mr. HOPPEL. I would definitely say that the corporation, perhaps more than—not more than anyone else. I am sure that medicare and the Federal programs are concerned about cost—have had a tremendous concern about the increase in costs which occurred basically in 1981 and 1982 and 1983. We are seeing some major slackening off in terms of percentages of premium increases, and that is how they see costs. Yes, there has been a lot of concern shown.

There is one large coalition here in the Seattle area of major employers. And we do not participate in that coalition. There are a number of coalitions around the country. And in some cases the insurers in the Blue plans participate, in other cases they do not. We do not, but we work very closely with them. We have people who serve on some of their committees. And I can assure you that there has been concern about what is happening to health care costs. And I think also concern about what is going to happen out in the future. I think if the major thrust of this proposal is really that of being a cost-containment kind of thing, then I think it is totally doomed to failure, because the things that result from changes in the delivery of the health care system that we might expect, let us say, as costs go higher and higher—I do not know whether that is a tax cap that is going to be raised as time progresses in some way, shape, or form. But pretty soon we get down to the point where people only have half coverage, and then we get into some disastrous kinds of situations. And I think the corporate community in this area has that kind of concern not only now, but out in the future. And this is our concern, is what is going to happen out in the future as we see the aged population—I can say this fairly safely, I am only 59, but 60 and above—start to grow and grow and grow. That is going to be a real problem over the next 5, 10, 15, 20 years. We try to look ahead, and our corporations, I know, try to look ahead also. So, I think this is merely a bandaid. I called it a Band-aid approach in my paper to cost containment, if that is indeed the thrust, because I do not think it will work.

I just happened to be glancing at a letter here from the Rand Corp. We did a study on the effect of changing coinsurances and that kind of thing, and this is what is going to result from, let us say, putting a cap on taxes. They are going to doodle around with the benefits, you see. And I noticed that Dr. Newhouse of the Rand Corp. wrote in 1981 that—he presented me some initial data here which your staff might find interesting if they have not seen it. But we hope to complete the analysis of the data by 1984, although they may be a bit optimistic. That is his staff. It is getting close to the middle of 1984. I am waiting for the final report.

But this study really should give some better insight into what happens when you start changing the methods of financing some of the health care premiums.

Senator **Gorton**. Thank you.

Gordon, obviously from the time the organizations were put together, the home builders, both National and State, have been fierce defenders of interest deductions and most particularly home mortgage interest deductions. I think you were here early enough this afternoon to hear one of our academics state that it was his view that two things would happen if we eliminated this deduction. One would be that interest rates would go down substantially, and the other would be that the value of homes would go down substantially. And the net result would be a gain for this $35,000 a year individual looking to buy the first home. Any comment?

PRICE OF HOMES NOT LIKELY TO DROP WITH 15-PERCENT INTEREST RATE

Mr. **Koetje**. First of all, I do not believe that the price of a home can go down when you have an interest rate of over 15 percent which we deal with and home mortgages are higher.

Second, I feel that if you take the deduction credits from home mortgages away, again stating here that the people will not be able to afford to buy those homes. Fortunately we builders are maybe flexible enough we can become scholars or something to overcome our problem. I hear a lot of comments about large corporations. I do not know how large you have to be, and I would like to maybe ask you that question. How much money do you have to make in a year's time before you do not pay any taxes? This puzzles me because I know from my own personal experiences last year, I thought I had made quite a bit of money until I got done paying my taxes.

Senator **Gorton**. A lot larger corporation than yours before you get to that point.

Mr. **Koetje**. Yes, evidently. And I had one representative tell me that a person who makes $200,000 a year does not pay any taxes. That is a fallacy. There are all different kinds of approaches that I have heard: straight-across-the-board taxes. Where is that level going to be?

PRIVATE ENTERPRISE DOES NOT CONTROL ITS OWN DESTINY

I am concerned that we are going to try and make so many changes to balance the deficit or to take care of that deficit problem which we in private enterprise only create one way, and that is we spend more than we make. And if it does take some adjustment which a lot of us—thanks to Government—had to make adjustments in 1980, which was something that was unusual for us. We always usually created our own problem. We overbuilt. Everybody was looking for a job. The market went back. They started purchasing the older built homes. And then we went back to work. But when the Federal Government does it to you, it really makes you open your eyes and realize that you are not in control of your own destiny anymore. And that concerns us, that the Federal Government can take—and you saw the chapter 11's. I am sure you are aware of them. You probably have had many a phone call at night—what the Federal Government has done to private enterprise. Private enterprise will do it to themselves without the help of the Federal Government. And I believe you are on the right track. I said that in here. I think that we do need help. I think you are doing the right thing by getting the input from all these different organizations because the builders are not all right.

I hope that from what I heard here today, some of the other people are not all right either. And I believe you should be commended for what you are proposing to do in trying to figure out the answers.

TACKLING PROBLEM PIECEMEAL IS DIFFICULT

Senator **Durenberger**. I guess that is a fitting comment on which to end the hearing or to go back to your reference of a time to put down the axes and pick up the chips. It is obviously frustrating to have everybody come in and say, "Do not touch my piece of the pie." But I guess we have heard it now for 4 years we have been together (addressing Senator Gorton), which is the period of time in which we decided to start picking up some chips. And the problem is we would only pick up a handful and we would leave a whole bunch behind. And then the handful that got picked up would get madder than hell because we should have picked up all the chips. Well, we could not pick up all the chips because some of them were old folks chips or poor people chips or AFL–CIO chips or Chamber of Commerce chips of something like that. And I guess I agree that it is very difficult for us to tackle this piecemeal. I mean, it has to be a collective process; otherwise, it is difficult for anybody to give up any piece of it. And what we have been exploring with these questions about the interest deduction obviously is not necessarily the elimination of the interest deduction, but what is the role of tax policy vis-a-vis decisions to borrow money and use that borrowed money for some specific purpose?

One of the problems, as I suggested in the markup this year in the tax bill, I just asked the Joint Tax Committee for some estimates on how much we would increase revenue if we limited the total interest deduction to 97 percent of what an individual would have. In other words, everybody would lose 3 percent of their total. And I will tell, by 2 hours later, Clarence Pierman, who is your counterpart in Minnesota, was on the telephone to me saying, "Hey, are you out of your tree? Do not touch the interest deduction."

So, even if I started at the other end, which was the interest on credit card financing or something like that, the folks at your end would start saying, "Do not touch it at all." I can tell that is not your message here. I mean, your message really is that housing is in trouble, not just homebuilders; but the cost of shelter is in trouble. And that unless you can guarantee us a total economic recovery, a reduction in interest rates, an improvement in this whole thing, we are relatively hesitant to start participating, even in talking about maybe limiting it to 97 percent or doing something about the inequities that are created between the $65,000 and the $650,000 mortgage in terms of equitable financing.

FEDERAL GOVERNMENT SHOULD STOP BORROWING

Mr. KOETJE. You can correct me if I am wrong, but it seems to me that I either read it or heard it that any percentage of unemployment over 5 percent, for every 1 percent it costs the Federal Government $30 billion, $5 billion in benefits, and $25 billion in lack of revenue.

It seems to me that if we as business people have to operate within our income, then if the Federal Government could operate within their income, automatically we would not be competing for the same commodity, and that is money, which would then reduce the interest rate, which then would put maybe 3 to 4 percent of the people back to work, because it is a rippling effect. And the housing industry picks up, the auto industry picks up, and grocery stores start getting busier. People are not eating dog food. They are eating hamburger or steaks. And it is a rippling effect. And somebody was saying the other day—they put it out before all the kids got out of school—but I think it was 7.9 or something like that. I think that was probably not true. But I have to go by some of the things we read. I think if you took the millions of kids that just came on the job market, it is devastating what the unemployment can do to our country. And to me, if we have to make some tradeoffs, get the Federal Government out of the commodity of money, borrowing, so that the interest rates will drop and people can afford to buy homes, which then stimulates more activity. That is where we are coming from.

I think anybody is afraid of an unknown. When we feel that somebody has started to mess around with what we have been accustomed to for the last how many years, with just minor changes, we feel right now there are some proposals for real drastic changes. And we feel one of them is the mortgage interest deductions. We feel that that would be devastating to our industry. Maybe we would learn to live with it. Maybe the gentleman that says, "I could build a house cheaper and the interest rates would come down," maybe he is right. I do not believe that.

CAP COULD LEAD TO INCREASED UTILIZATION OF HOSPITAL INPATIENT SERVICES

Senator **Durenberger**. Mr. Hoppel, I just want to explore from your own experience whether this is supposition or experience when you talk about the fact that a cap would result in increased utilization because there would be arbitrary iimitations on health care subscription and premium cost. I did not quite follow that logic.

Mr. **Hoppel**. I think what I am saying there is that it could lead to increased utilization of hospital inpatient services, which are more expensive.

Senator **Durenberger**. How would that follow?

Mr. **Hoppel**. By virtue of the fact that if people's benefits for outpatient kinds of services, going to the doctor's office not unnecessarily—but there are people, if they do not have coverage, they may have the start of a serious condition. And if they have adequate coverage—of course, this is why we like to some extent the HMO concept of preventive care—if something gets started in terms of an illness which can be nipped in the bud and it is not nipped, then it can develop into a serious hospital admission. And I think that is what I meant by that particular comment.

Senator **Durenberger**. You said out here you are seeing more companies go to cost-sharing. What has been the experience? As Slade points out, the pressures have been high, which really has nothing to do with tax breaks or anything. It just the fact that premium increases——

Mr. **Hoppel**. Yes, absolutely.

Senator **Durenberger** [continuing]. Have been like 40 percent, 50 percent, whatever it is, in a couple of years. What then is the first thing that people do? Do they get rid of benefits, or do they go to cost-sharing, assuming they are not a first-dollar coverage company that just is scared to death of what their employees will do to them?

Mr. **Hoppel**. I think they do both, Senator. I think they go both to cost-sharing and to eliminating some forms of benefits.

Senator **Durenberger**. Have you got some examples in the last couple years?

Senator Gorton. Which benefits?

ANCILLARY BENEFITS BEING DROPPED

Mr. Hoppel. I am talking about the prescription drug benefits, dental benefits. They are more of the ancillary kinds of benefits. We have seen a number of employers eliminate those kinds of ancillary programs, which in themselves may not be all that important. But what they really do is tend more toward a higher deductible and greater coinsurance.

Senator Durenberger. Are these, in this part of the country, also situations where the employer has one plan basically for the employees or maybe two, and the employer is deciding what the set of benefits is and the employee is not?

Mr. Hoppel. It all depends. We have a number of negotiated contracts out here that are maintenance-of-benefit kinds of programs.

Senator Durenberger. Who is dropping the dental coverage? I guess that is my question. Are employees individually deciding they do not want dental coverage?

Mr. Hoppel. No, I am talking about when the whole package is provided by an employer.

Senator Durenberger. OK, the employer is saying we cannot——

Mr. Hoppel. The employer is saying: If we have got to cut something, let us cut the dental benefits, let us cut the vision benefits, and those kinds of things. I do not know, outside of some very rare cases, that that has as much of an effect as the removal of a person's comfort level in utilizing physician services early on in terms of preventative care. The thing that is so darn hard to delineate is the unnecessary visit to the doctor's office versus the visit that might very well preclude a hospitalization expense that is substantial if again, as I say, something is nipped in the bud. And that is why I also stated we feel that there is so much validity to the HMO concept. I see it down the pike as being an alternative, a viable alternative. And I am not against a fee for service. I just am a pragmatist, and I have to ride with what I see. And I see that getting to doctors on the risk quite a bit more than they are now is going to help us slow down. And it cannot cut back costs—slow down the fantastic potential for increases in costs that I see coming up when we talk about organ transplants and all of those kinds of things and the advances in technology. My goodness, in 5 years the cost factors are going to bulge because of those things and the population demographics.

Senator Durenberger. There is a sentence here that says this proposal—that is, the cap—would have the effect of forcing employers to develop more than one plan of coverage for their employees. That is not to be interpreted to mean that you are ruling out HMO plans?

Mr. Hoppel. Oh, no, no.

Senator Durenberger. What you seem to be fearful of is that we should not give individuals—you can give them a choice between this HMO and that HMO and that Blue Cross plan or an indemnity plan or something, but we do not want healthy people paying less and all that sort of thing.

Mr. **Hoppel**. If there is an option, that is what happens. And the younger age groups tend towards the lower premium, even if they are paying it themselves. The higher age groups obviously, because they are more aware of their health problems and have more, go to the higher premiums. It becomes a selective kind of thing. The premiums increase disproportionately in the older age population, and decrease disproportionately in the lower. And pretty soon one of them is priced right out of the market. That is what we are concerned about.

Senator **Durenberger**. Thanks.

Senator **Gorton**. Thank you both very much. We are adjourned.

[Whereupon, at 4:56 p.m., the committee was adjourned.]

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